



Questions and answers

on the ESRB report on the macroprudential policy issues arising from low interest rates and structural changes in the EU financial system

1. Why has the ESRB analysed low interest rates and structural changes in the EU financial system?

The ESRB is responsible for the macroprudential oversight of the financial system within the Union. Therefore, it must contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system. Interest rates are a fundamental variable for the functioning of the financial system and, as such, the ESRB has deemed it necessary to assess, with a forward looking perspective, the financial stability implications deriving from a prolonged period of low interest rates. In addition to low interest rates, the EU financial system is now facing a time of structural change, which will shape its future and which deserves consideration from a macroprudential perspective.

2. Why did the ESRB decide to analyse low interest rates together with structural changes in the EU financial system?

Low interest rates and structural changes are closely intertwined within the EU financial system. It would be difficult and artificial to try to disentangle the effects of each one of them on the different participants in the financial system and on the system itself. At the same time, low interest rates may trigger or accelerate structural changes in the EU financial system. Therefore, the ESRB has analysed both phenomena together.

3. In what way is the EU financial system structurally changing? Are the changes expected to result in benefits or risks to financial stability?

The EU financial system is currently undergoing several structural changes, such as the increasing importance of non-banks in financial intermediation, the influence of FinTech and regulatory reform following the global financial crisis, coming at the same time as the banking union, in the euro area countries, and the capital markets union initiative. If they occur smoothly, these structural changes would bring benefits to the Union. However, if the transition proves difficult or if new risks are not given due consideration, financial stability over the long term may be threatened.

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4. What hypothetical scenarios have been considered by the ESRB in this work?

The ESRB has analysed whether the current low interest rate environment and ongoing structural changes might cause vulnerabilities and become sources of systemic risks in the long term, either for the EU economy as a whole or for specific regions and sectors within the European Union. To this end, two hypothetical scenarios have been considered: one where interest rates are expected to remain low for a prolonged period of time mainly because of structural factors (a “low for long” scenario); the other where low interest rates are closely linked to the cyclical factors and, hence, are expected to return to previous levels in the medium term (the “back to normal” scenario). Taking these two scenarios as a starting point, the work of the ESRB has covered the determinants of the current low level of interest rates, the identification and assessment, with a forward-looking approach, of the risks across sectors in the financial system, and the potential policy options for mitigating or preventing adverse developments in the EU financial system.

5. What does the ESRB consider to be the main financial stability risks from a prolonged period of low interest rates?

Looking ahead, the main risks arising from a prolonged period of low interest rates are:

- low profitability and weakening resilience in some sectors of the financial system, notably guaranteed-return life insurers and defined-benefit pension funds but also banks, due to declining net interest margins;
- broad-based risk taking affecting financial markets;
- risks related to an accelerated transition to a more market-based structure, where bank-like activities are increasingly provided by non-banks and where the limited ability to assess risks in the shadow banking sector may become a key concern for macroprudential policy.

6. Would an increase in interest rates result in macroprudential risks?

The ESRB has also considered the financial stability implications of a gradual increase in interest rates, returning to levels seen prior to the global financial crisis. Risks identified in this scenario refer mostly to the unwinding of positions taken during the time when interest rates were low. Two examples of these risks are those stemming from the stock of loans granted with a fixed rate at low levels or from crowded positions in higher-risk assets. In general, these risks have been considered to be of lesser importance than those stemming from a prolonged period of low interest rates, as the gradual recovery of interest rates would be driven by a recovery in economic growth under the “back to normal” scenario.

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7. Which parts of the EU financial system are at risk from a prolonged period of low interest rates?

The ESRB notes that some of the identified risks posed by low interest rates and structural changes can already be observed and may develop further over time. These are risks related to the sustainability of business models and to broad-based risk taking. The ESRB has recently observed some indications that business models need to adjust to the new environment, in particular in the life insurance and defined-benefit pension funds sectors. Bank profits have also been affected by low interest rates but the overall picture here is more complicated. The identified risks in the area of broad-based risk taking relate mainly to segments of the financial markets, where prices and risk premia may be misaligned with the fundamentals of the underlying assets.

8. What is the ESRB currently doing to mitigate these risks?

The leading role for most of the policy options outlined in the report do not fall within the ESRB's competence; they must be addressed by other institutions instead (i.e. national macroprudential authorities or European institutions). In some areas, though, the ESRB is currently working on policy proposals. First, the report highlights how capital markets are evolving and bringing significant structural change to the EU financial system. Here, the ESRB is developing a macroprudential toolkit for non-banks, given the expected growing importance of these institutions in the coming years.¹ Second, the ESRB has published a recommendation on closing data gaps in the area of commercial and residential real estate². This recommendation is closely linked to the policy proposals made in the ESRB report for real estate,³ since availability of data is a prerequisite for effective monitoring of developments in real estate markets. And third, the ESRB is also calling for a revision of the liquidity and leverage requirements across sectors, including those applied to investment funds. On this point, the ESRB has been assessing the liquidity conditions in financial markets and has recently published a report with the first findings of that assessment.⁴

9. Should policies be taken to mitigate or prevent these risks from materialising? If so, which policies would be appropriate?

The choices as to which policy actions to take in the ESRB report are divided between those that are aimed at addressing risks already observed and which may develop over time, and those that deal with conjectured future risks.

¹ See Macroprudential policy beyond banking: an ESRB strategy paper ([link](#)).

² See Recommendation ESRB/2016/14 on closing real estate data gaps.

³ See ESRB reports on residential and commercial real estate and financial stability in the EU ([link](#) and [link](#)).

⁴ See the ESRB's report, Market liquidity and market-making ([link](#)).

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The risks that can currently be observed and may develop over time relate mainly to the sustainability of business models and broad-based risk taking. The ESRB's policy proposals are aimed at increasing the resilience of institutions, resolving or consolidating unsustainable institutions, enhancing the monitoring of risk taking and enhancing resilience to risk revaluation. The proposals cover, among others, a swift introduction of the Basel guidance on interest rate risk in the banking book; the consideration of the low interest rate environment in the ongoing implementation of the Solvency II Directive (2009/138/EC) and its future review; and a substantial enhancement of the monitoring of financial and real asset valuations.

Risks of a conjectured nature fall within the fields of broad-based risk taking and changes in the financial structure. The ESRB proposes policy options aimed at enhancing the monitoring of risk taking, increasing resilience to risk revaluation, designing system-wide stress tests and developing a macroprudential toolkit for non-banks. Mention should also be made of proposals towards increased cooperation across sectoral stress tests, the development of macroprudential policy beyond banking and the improvement of analysis on interconnectedness in the EU financial system, among others.

10. Given its mandate to issue warnings and recommendations about significant systemic risks, is the ESRB issuing a warning about risks arising from low interest rates and structural change in the EU financial system?

In publishing this report, the ESRB is not issuing any warning about risks arising from low interest rates and structural changes. The ESRB does not deem it necessary to issue a warning on the topic for now.

11. The ESRB report proposes a catalogue of policy options to mitigate and prevent the materialisation of these risks. Is the ESRB making a formal recommendation about policy measures?

The policy options proposed in the report do not have any legal force, unlike an ESRB recommendation. At this stage the ESRB has decided to make these proposals public as it deems them useful for preventing and mitigating the identified risks. The ESRB has intentionally not put them in the form of the soft-law instruments envisaged in the ESRB Regulation (warnings or recommendations). Nonetheless, the ESRB does expect relevant institutions to consider taking any of the proposed (where these fall under their mandate) in order to raise the structural resilience of the financial system. These proposed actions include regulatory initiatives, which are linked to some of the European-wide policy proposals in the report.

12. Which of the proposed policies are intended for banks?

One important policy proposal for banks relates to greater recognition of interest rate risk in the regulatory capital framework. To this end, the ESRB is proposing swift implementation into the Capital Requirements

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Directive (CRD) of the recently agreed Basel Committee on Banking Supervision's standard on interest rate risk in the banking book (IRRBB), in order to increase banks' resilience to the current environment. The ESRB is also calling for the resolution framework for banks to become fully operational, at both national and EU levels. Significant progress has been made so far in this area and it remains essential to maintain that level of progress with the remaining aspects of the resolution policy work which are yet to be finalised. Other policy options proposed by the ESRB refer to banks indirectly, such as policy options related to price misalignments in real estate markets, the monitoring of credit standards at national level, or the system-wide stress tests.

13. Which of the proposed policies are intended for insurers?

Insurance firms that typically guarantee a certain return have been severely impacted by the prolonged period of low interest rates; the ESRB has consequently given high priority to policies in this area. In broad terms, there is a need to consider the low interest rate environment in the ongoing implementation of the Solvency II Directive and in its future reviews. More precisely, this means a revision of the risk free rate (notably of the ultimate forward rate methodology) and of relevant areas in the long-term guarantee package. The ESRB is also proposing to explore other possible prudential tools that could be made available to competent authorities to increase resilience in individual insurers most affected by a prolonged period of low interest rates. Such prudential tools could include (i) requesting a reduction in the maximum level of interest rate guarantees offered in new contracts; (ii) granting powers to cancel or defer dividend distributions (even before the Solvency Capital Requirement, SCR, is breached) or powers to introduce discretionary benefits limitation options; and (iii) retaining more capital. All these steps are aimed at increasing the resilience of insurers. In addition, in cases where business models are proving to be unsustainable, the ESRB will call for effective recovery and resolution processes to be developed for insurers, at both EU and national level.

14. Which of the proposed policies are intended for pension funds?

Similarly to insurance firms, pension funds have become vulnerable to the extended period of low interest rates. The proposed policies covering pension funds refer to the endorsement of the recent EIOPA Opinion, which calls for the strengthening of the EU regulation applicable to pension funds with a common framework for risk assessment and transparency, including market-consistent valuation of liabilities.⁵ The IMF's latest Global Financial Stability Report contains a similar recommendation.⁶ At the same time, the ESRB is also calling for an in-depth analysis of the interaction and potential systemic impact that underfunded pension funds would have on the real economy. Given the heterogeneity of

⁵ See <https://eiopa.europa.eu/Pages/News/EIOPA-recommends-to-enhance-risk-assessment-and-transparency-of-pension-funds.aspx>

⁶ See <http://www.imf.org/external/pubs/ft/gfsr/2016/02/>

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pension arrangements across Member States, differences between Member States must be taken into consideration in this analysis.

15. Which of the proposed policies are intended for investment funds and asset managers?

Broad-based risk taking has been identified as one of the main vulnerabilities arising from a prolonged period of low interest rates and structural changes in the EU financial system. A number of policies proposed to prevent and mitigate these risks refer to asset managers and investment funds. The policies relate mostly to liquidity and leverage and include a revision of the potential need to increase liquidity or leverage requirements for investment funds as a way to enhance resilience to risk revaluation. The policies also refer to the possibility of more disclosure of information by investment funds – covering leverage, liquidity, funding and collateral re-use – as a means of enhancing the monitoring of risk taking across the financial system. Furthermore, the policy proposals for developing a macroprudential toolkit for non-banks and designing a system-wide stress test are also indirectly addressed to asset managers and investment funds.

16. Which of the proposed policies are intended for financial market infrastructures?

Whereas levels of interest rates are key to the functioning of banks, insurance firms and pension funds, market infrastructures are not so much affected and therefore face fewer risks from a low interest rate environment. Despite this, two of the policy options proposed by the ESRB refer indirectly to market infrastructures. First, the call for the development of a macroprudential toolkit for non-banks is also expected to cover market infrastructures; in particular, the ESRB proposes to develop margins and haircuts as macroprudential instruments. Second, the ESRB is calling for increased collaboration among EU regulators in the area of stress tests, so as to consider common shocks related to asset prices and liquidity with the overarching goal of undertaking system-wide stress tests in the long term. Stress tests of central counterparties (CCPs), currently within the remit of the European Securities and Markets Authority (ESMA), also come under this proposal. In both cases, the ESRB understands that the proposals need to be implemented over a long-term horizon.

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