I

(Resolutions, recommendations and opinions)

RECOMMENDATIONS

EUROPEAN SYSTEMIC RISK BOARD

WARNING OF THE EUROPEAN SYSTEMIC RISK BOARD

of 22 September 2022

on vulnerabilities in the Union financial system

(ESRB/2022/7)

(2022/C 423/01)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to the Treaty on the Functioning of the European Union,

Having regard to the Agreement on the European Economic Area ([1]), in particular Annex IX thereof,

Having regard to 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 ([2]), and in particular Article 3(2)(c) and Articles 16 and 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board ([3]), and in particular Article 18 thereof,

Whereas:

(1) The Union's financial system has proved to be resilient so far to increasing geopolitical tensions and economic uncertainty. However, the probability of tail-risk scenarios materialising has increased since the beginning of 2022 and has been exacerbated by recent geopolitical developments. Risks to financial stability may materialise simultaneously, thereby interacting with each other and amplifying each other's impact. Rising geopolitical tensions have led to an increase in energy prices, causing financial distress to businesses and households that are still recovering from the adverse economic consequences of the COVID-19 pandemic. In addition, higher-than-expected inflation is tightening financial conditions.

(2) These developments weigh on the Union's macroeconomic outlook. Gross domestic product (GDP) growth forecasts have been revised downwards for 2023 and the probability of a recession during the winter of 2022/2023 has increased. Downside risks differ across Member States, in particular on account of their varying degree of dependence on energy imports from Russia and the diverging energy-intensity of production chains. Overall, the probability of a materialisation of tail-risk scenarios hinges on a further escalation of geopolitical tensions; the extent and duration of the economic downturn; and the persistence of high inflation.

([1]) OJ L 1, 3.1.1994, p. 3.
([2]) OJ L 331, 15.12.2010, p. 1.
([3]) OJ C 58, 24.2.2011, p. 4.

(3) The European Systemic Risk Board (ESRB) had communicated its concerns about heightened uncertainty and the increased probability of tail-risk scenarios materialising earlier this year [4]. The further rise in financial stability risks now warrants the issuance of a General Warning, in line with the ESRB's mandate. Three severe systemic risks to financial stability have been identified.

(4) First, the deterioration in the macroeconomic outlook combined with the tightening of financing conditions implies a renewed rise in balance sheet stress for non-financial corporations (NFCs) and households, especially in sectors and Member States that are most affected by rapidly increasing energy prices. These developments weigh on the debt-servicing capacity of NFCs and households.

(5) Second, risks to financial stability stemming from a sharp fall in asset prices remain severe. This has the potential to trigger large mark-to-market losses, which, in turn, may amplify market volatility and cause liquidity strains. In addition, the increase in the level and volatility of energy and commodity prices has generated large margin calls for participants in these markets. This has created liquidity strains for some participants.

(6) Third, the deterioration in macroeconomic prospects weighs on asset quality and the profitability outlook of credit institutions. While the European banking sector as a whole is well capitalised, a pronounced deterioration in the macroeconomic outlook would imply a renewed increase in credit risk at a time when some credit institutions are still in the process of working out COVID-19 pandemic-related asset quality problems. The resilience of credit institutions is also affected by structural factors, including overcapacity, competition from new providers of financial services as well as exposure to cyber and climate risks.

(7) In addition to these three severe systemic risks to financial stability, the ESRB has also identified the following elevated systemic risks.

(8) Vulnerabilities in the residential real estate sector rose further in many Member States in the first half of 2022 on the back of buoyant house price and mortgage lending growth, implying a further build-up of cyclical risks. However, rising mortgage rates and the worsening in debt-servicing capacity due to a decline in real household income can be expected to exert downward pressure on house prices and lead to a materialisation of cyclical risks.

(9) The deterioration in the macroeconomic outlook also compounds challenges for the commercial real estate (CRE) sector, reflecting rising financing costs and construction prices, bottlenecks in the supply of construction materials as well as structural trends such as lower demand for office space. Given that profit margins in the Union's CRE sector are already low, these developments could render some existing or planned CRE investment projects non-profitable, increasing default risks and compounding concerns about CRE-related non-performing loans, which are already high and rising.

(10) The war in Ukraine has increased the probability of large-scale cyber incidents, which may disrupt critical economic and financial infrastructures, and impair the provision of key economic and financial services.

(11) The slowdown in economic growth and the tightening of financial conditions are weighing on medium-term sovereign debt dynamics. High public indebtedness remains one of the main macroeconomic vulnerabilities in several Member States.

(12) The increase in systemic risks to financial stability calls for a decisive policy response. Preserving or enhancing the resilience of the Union's financial sector remains essential to ensure its capacity to support the real economy if and when financial stability risks materialise.

([4]) Press release of 31 March 2022, following the 45th regular meeting of the General Board of the ESRB on 24 March 2022 and press release of 30 June 2022, following the 46th regular meeting of the General Board of the ESRB on 23 June 2022, available on the ESRB's website at www.esrb.europa.eu.

(13) Union and national supervisory authorities in the banking and non-banking financial sectors contribute to the resilience of the Union's financial sector by monitoring and addressing vulnerabilities of the financial system and of the institutions under their remit, in close collaboration with each other. Relevant authorities should avail themselves of the full range of micro- and macroprudential tools to contain these risks and mitigate their impact, should they materialise. Where macroprudential tools are not available, authorities may need to make use of their supervisory powers to mitigate risks to financial stability and ensure that markets do not become impaired. Close coordination between relevant authorities would enhance the efficiency and effectiveness of policy responses, in particular to address cross-sectoral and cross-border risks, while avoiding procyclicality, market fragmentation and negative externalities for other Member States.

(14) Credit institutions can act as a first line of defence, by ensuring that their provisioning practices and capital planning properly account for expected and unexpected losses that may be caused by the deterioration in the risk environment. This includes proactively and regularly adjusting their own capital projections under baseline and adverse scenarios. The latter should reflect sufficiently conservative and updated macroeconomic scenarios, assuming severe, but plausible stress for prolonged periods. Credit institutions should also ensure good visibility of their near-term liquidity risks and concrete contingency plans to tackle these risks. This is also key to whether any materialisation of financial stability risks and to preserve market confidence in credit institutions.

(15) Complementing credit institutions' prudent risk management practices, micro- and macroprudential capital buffers that are consistent with the prevailing level of risk help to ensure credit institutions' resilience. Some national authorities have already tightened macroprudential policies, while others are currently exploring whether macroprudential policies could be implemented to address vulnerabilities. Preserving or further building up macroprudential buffers would support credit institutions' resilience and enable the authorities to release these buffers, if and when risks materialise and negatively impact credit institutions' balance sheets. This, in turn, would strengthen credit institutions' ability to absorb losses, while maintaining the provision of critical services to the real economy. Macroprudential policy decisions should be made considering each Member State's specific macro-financial outlook and banking sector conditions, in order to limit the risk of procyclicality.

(16) Financial stability risks beyond the banking sector should also be addressed. This requires tackling vulnerabilities and increasing the resilience of non-bank financial institutions and market-based finance. Tackling liquidity and funding strains for NFCs participating in energy derivative markets is crucial. However, prudential requirements for central clearing should not be relaxed. In addition, close attention should be paid to structural liquidity mismatches in certain types of investment funds. Fund managers should also be encouraged to make use of liquidity management tools when needed. Furthermore, with respect to insurance, stretched household balance sheets heighten the risk of insurance contract lapses, potentially widening the protection gap but also making liquidity monitoring relevant.

(17) By ensuring that their risk management practices adequately reflect the deterioration in the risk environment and by heeding supervisors' guidance and expectations, non-bank financial institutions themselves can further strengthen their resilience and help prevent tail risk scenarios from materialising. For example, for investment funds, this means close monitoring and addressing possible excessive liquidity mismatches or leverage; for central counterparties (CCPs), clearing members and their clients, this means monitoring derivative exposures as well as addressing concentration risk and procyclicality in margining practices along the chain of CCPs, clearing members and their clients; and for insurers, this means paying close attention to market and liquidity risks, which could materialise in a scenario of increased market volatility and high uncertainty.

(18) The ESRB has repeatedly noted [5] that a lack of tools is hampering authorities' ability to address financial stability risks beyond the banking sector. It has called for authorities to be provided with such tools, for example, in the context of the review of the prudential rules governing investment funds and insurers. The current heightened risk environment makes this more urgent,

HAS ADOPTED THIS WARNING:

SECTION 1

Warning

The Union's financial system has proved to be resilient so far despite increasing geopolitical and economic uncertainties. However, the European Systemic Risk Board (ESRB) has identified a number of severe risks to financial stability. These risks may materialise simultaneously, thereby interacting with each other and mutually amplifying their impact. The probability of tail-risk scenarios materialising has increased since the beginning of 2022, and has been exacerbated by recent geopolitical developments. These geopolitical developments impact energy prices and supply, implying a renewed rise in balance sheet stress for businesses and households. Moreover, higher-than-expected inflation is tightening financial conditions, which may amplify stress in the financial sector.

A pronounced deterioration in economic activity could lead to a renewed increase in credit risk at a time when some credit institutions are still in the process of addressing COVID-19 pandemic-related asset quality issues that have so far been limited due to extensive public support measures. Risks to financial stability stemming from a sharp fall in asset prices also remain severe. Rising mortgage rates and the deterioration in debt servicing capacity on account of a decline in real household income could exert downward pressure on house prices. In turn, this could trigger the materialisation of accumulated cyclical risks in real estate markets. In addition, the probability of large-scale cyber incidents impacting the financial system has increased.

Given the increase in systemic risks to financial stability, the ESRB considers it necessary for private sector institutions, market participants and relevant authorities to continue to prepare for materialisation of tail-risk scenarios. Preserving or enhancing the resilience of the Union's financial sector remains essential so that the financial system can continue to support the real economy if and when financial stability risks materialise. Close coordination between relevant authorities and prudent risk management practices across all financial sectors and market participants remain key to addressing vulnerabilities effectively, while avoiding market fragmentation and negative externalities for other Member States.

Credit institutions can act as a first line of defence by ensuring that their provisioning practices and capital planning properly account for expected and unexpected losses that may be caused by the deterioration in the risk environment. This includes proactively and regularly adjusting their own capital projections under baseline and adverse scenarios. The latter should reflect sufficiently conservative and updated macroeconomic scenarios, assuming severe, but plausible stress under prolonged periods. Furthermore, by anticipating and preparing for near-term liquidity risks, credit institutions ensure their immediate resilience, should any of the risks mentioned above materialise.

Complementing credit institutions' prudent risk management practices, micro- and macroprudential capital buffers that are consistent with the prevailing level of risk help ensure banking sector resilience. Preserving or further building up macroprudential buffers would support credit institutions' resilience and enable the authorities to release these buffers, if and when risks materialise and negatively impact credit institutions' balance sheets. At the same time, macroprudential policy decisions should be made considering Member State-specific macro-financial outlooks and banking sector conditions, to limit the risk of procyclicality.

[5] Recommendation ESRB/2017/6 of the European Systemic Risk Board of 7 December 2017 on liquidity and leverage risks in investment funds (OJ C 151, 30.4.2018, p. 1). Macroprudential policy beyond banking: an ESRB strategy paper, 19 July 2016; ESRB response to the EIOPA Consultation Paper on the 2020 review of Solvency II, 17 January 2020; and, Response Letter to a Consultation of the European Commission on the review of Solvency II, 16 October 2020, available on the ESRB's website at www.esrb.europa.eu.

Financial stability risks beyond the banking sector should also be addressed. This requires tackling vulnerabilities and increasing the resilience of non-bank financial institutions and market-based finance. Where macroprudential tools are not available, authorities may need to make use of their supervisory powers to mitigate the consequences of the materialisation of financial stability risks and ensure that markets do not become impaired. Relevant authorities should also continue to monitor risks closely and enhance supervisory dialogue with supervised non-bank financial institutions where needed. By ensuring that their risk management practices adequately reflect the heightened risks and by heeding supervisors' guidance and expectations, non-bank financial institutions can further strengthen their resilience themselves.

Beyond the financial sector, liquidity strains for non-financial corporations participating in the energy derivatives markets also need to be tackled. However, this should not come at the cost of relaxing prudential requirements for central clearing systems.

SECTION 2

Definitions

For the purposes of this Warning the following definitions apply:

(a) 'relevant authorities' means:

— the ECB for the tasks conferred on it in accordance with Articles 4(1), 4(2) and 5(2) of Council Regulation (EU) No 1024/2013 ([6]);

— the European Supervisory Authorities;

— the national supervisory authorities;

— designated authorities pursuant to Chapter 4 of Title VII of Directive 2013/36/EU of the European Parliament and of the Council ([7]) or Article 458(1) of Regulation (EU) No 575/2013 of the European Parliament and of the Council ([8]);

(b) 'European Supervisory Authorities' means the European Supervisory Authority (European Banking Authority) established by Regulation (EU) No 1093/2010 of the European Parliament and of the Council ([9]), together with the European Supervisory Authority (European Insurance and Occupational Pensions Authority) established by Regulation (EU) No 1094/2010 of the European Parliament and of the Council ([10]) and the European Supervisory Authority (European Securities and Markets Authority) established by Regulation (EU) No 1095/2010 of the European Parliament and of the Council ([11]);

([6]) Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).
([7]) Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).
([8]) Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).
([9]) Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC (OJ L 331, 15.12.2010, p. 12).
([10]) Regulation (EU) No 1094/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Investment and Occupational Pensions Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/79/EC (OJ L 331, 15.12.2010, p. 48).
([11]) Regulation (EU) No 1095/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC (OJ L 331, 15.12.2010, p. 84).

(c) 'national supervisory authority' means a competent or supervisory authority in a Member State as specified in Article 4(1), point (40), of Regulation (EU) No 575/2013 and in Article 3(1), point (36), of Directive 2013/36/EU; in Article 13, point (10), of Directive 2009/138/EC of the European Parliament and of the Council [12], in Article 67(1) of Directive 2014/65/EU of the European Parliament and of the Council [13] and in Article 22(1) of Regulation (EU) No 648/2012 of the European Parliament and of the Council [14].

Done at Frankfurt am Main, 22 September 2022.

The Head of the ESRB Secretariat,
on behalf of the General Board of the ESRB
Francesco MAZZAFERRO

[12] Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

[13] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (OJ L 173, 12.6.2014, p. 349).

[14] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201, 27.7.2012, p. 1).