THE EUROPEAN SYSTEMIC RISK BOARD IN "CRISIS MODE"

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NB: During the period discussed here, the author was Chair of the ESRB Advisory Scientific Committee and had various roles in the work described. This article is written entirely on his personal responsibility, with no implication of any member of ESRB staff or members of the various committees, nor any review by ESRB.

In response to the Covid-19 crisis and while both monetary and fiscal authorities were taking direct and unprecedented measures to curb the adverse consequences of this pandemic shock on the real economy, the European Systemic Risk Board (ESRB), i.e. the European Union macroprudential authority that is responsible for financial stability, swung into action. In particular, the ESRB identified five priority areas: (i) the implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy, (ii) market illiquidity and implications for asset managers and insurers, (iii) impact of procyclical downgrades of bonds on markets and entities across the financial system, (iv) system-wide restraints on dividend payments, share buybacks and other payouts and, (v) liquidity risks arising from margin calls. For each of the topics studied, this article sets out the main risks that were identified by the ESRB as well as the different policy recommendations and further steps that, according to the European Union macroprudential authority, should be taken.

The European Systemic Risk Board (ESRB) is the European Union macroprudential authority, responsible for financial stability: the prevention and mitigation of systemic risk. It was established at the end of 2010. The Chair is the President of the European Central Bank. The decision-making body is the General Board, whose members include all Governors of the 27 central banks of the European Union (EU), a member of the European Commission, the Chairs of the European Supervisory Authorities (ESAs: EIOPA – European Insurance and Occupational Pensions Authority, EBA – European Banking Authority, ESMA – European Securities and Markets Authority), and the Chair and two Vice-Chairs of the Advisory Scientific Committee (ASC). Decisions are normally by consensus, but votes may be taken if a matter is contentious. A quorum of two-thirds of the voting members is required for any decision, even if no vote is deemed necessary. The General Board and its committees and working groups are supported by a relatively small secretariat. The Advisory Technical Committee (ATC), with a very wide membership, discusses matters that might go to the General Board, and the Steering Committee (SC), chaired by the ESRB Chair, prepares General Board meetings.

The ESRB has no executive authority. It may issue recommendations to the ESAs and national regulatory bodies. These are not binding – they have the force of "act or explain". It may also issue warnings and letters to various EU and national institutions, and it publishes reports and research papers.

All this is directly relevant to the way in which the ESRB responded to the economic crisis consequent on the Covid-19 pandemic shock. Its efforts were directed to mitigating the financial stability risks arising from the economic crisis. The global financial crisis (GFC) of 2008-09 was generated endogenously, with a gradual buildup leading to a sharp and wide-ranging disruption of financial markets and institutions. The effects on output and employment were not as deep and immediate as those of 2020. The current crisis came from an exogenous shock, whose economic effects (both direct and arising from policy responses) have had actual and potential financial repercussions. In both cases, quick actions were required.

The policy responses of 2020 benefited from the lessons learned from the GFC and the resilience established by regulatory measures taken in its wake, including the creation of the ESRB and ESAs. But it is not straightforward to obtain quick decisions from a body that has 35 voting members with very different constituencies and normally meets only quarterly. The battle during the past year has been to move quickly and comprehensively to avoid a systemic financial crisis and underpin those parts of the financial system at greatest risk, while supporting financial policies aimed at the recovery of the real economy.

The European Central Bank (ECB) has monetary firepower that it can deploy with speed, but it must take care not to go beyond the borders of monetary policy. They are defined by its statutes, to some extent also by precedent and even judicial rulings. Limits to the ESRB mandate are less well defined, while its authority is more circumscribed. Importantly, its geographical reach includes eight countries not in the Economic and Monetary Union. Several are financially integrated with the euro zone in ways different from the financial integration within the euro zone.

Monetary and macroprudential policies should be complementary. If necessary monetary easing raises financial stability risks, macroprudential measures can reduce them. If monetary measures are intended to counteract negative shocks to the real economy, macroprudential policy can also be supportive. But this complementarity requires careful oversight, which is an advantage to having the President of the ECB as Chair of ESRB and the central bank governors as members of its General Board. This policy coordination is rather different from the equally desirable but politically more difficult coordination between monetary and fiscal policies.

There is another key aspect of coordination that is often neglected but proved to be important in responding to the 2020 crisis: dealing with cross-border spillovers of macroprudential policies.[1] These may arise within the euro zone, among euro zone and non-euro zone members of the EU, and between the EU 27 and the rest of the world, in particular the United States. National measures may affect multinational banks; microprudential supervisory interventions are unlikely to take a cross-border, systemic macroprudential perspective; EU-wide measures may affect the competitive position of EU institutions vis-à-vis those outside the bloc; market instability is often transmitted across borders; illiquidity in one country's markets may draw liquidity from the rest of the world. All these ideally require policy coordination. The ESRB is well suited to foster this coordination within the EU and at least to represent EU positions in the international context, if not to negotiate or take measures to protect EU interests directly.

Some of these issues arose immediately when the crisis broke. As the number of Covid-19 cases outside China rose during February 2020, markets were at first unaffected. But by the last week of February, "risk-off" attitudes were spreading and volatilities were rising, in Europe as well as in the United States. Increasing demand for safe assets pushed key government bond yields down, while high-yield corporate bond spreads rocketed upwards. Outflows from credit funds rose. Oil prices plummeted. The almost simultaneous statements from the heads of the four major central banks (President Lagarde on 2 March[2]) did not subdue the growing market turmoil.

Market conditions continued to deteriorate. The banks' countercyclical capital buffers were released, by individual regulators in an uncoordinated way, starting 8 March. On 12 March, the ECB announced a set of monetary policy and other measures. Still, there was no consensus on a financial stability emergency. But the markets knew. On 16 March, the markets crashed, and volatilities spiked – VIX, the "fear index", rose to a peak not seen since September 2008.

The ECB Governing Council met on 17 March, at the height of the "dash for cash" or "March madness". It launched the EUR 750 billion Pandemic Emergency Purchase Programme (including all assets then eligible under the existing asset purchase programme, but with greater flexibility). It expanded the eligible assets under the corporate sector purchase programme to include non-financial commercial paper. And it stated that "the ECB will ensure that all sectors of the economy can benefit from supportive financing conditions that enable them to absorb this shock."[3]

But the ESRB had already sprung into action. The secretariat had understood very early on that the pandemic emergency had led to a financial stability emergency. Following a pre-SC meeting on 10 March, the secretariat on 12 March set the stage for the SC, by laying out macroprudential measures that could be taken in response to the crisis. The ASC had wide-ranging meetings on 11 and 13 March to discuss systemic weaknesses and possible policy responses. The SC, in its meeting on 17 March, decided to go into "crisis mode". The secretariat was charged with launching a consultation to determine a list of "priority topics". After internal discussions, including the Chair of the ASC, a list of ten topics was put to General Board members, who were asked to choose five by a written procedure (not a meeting, at that stage). The SC met again on 25 March to discuss policy responses to the crisis and priorities for ESRB work. Markets had by then stabilised, but there was concern that national authorities had acted in an uncoordinated manner, over a wide range.

It has to be said that the process could have been even quicker. Some time was lost because there was not an early consensus around the ESRB secretariat view. This may have been partly an initial resistance to centralised action on the part of national authorities and various agencies. The ESRB does not have a natural constituency. Not all General Board members, and fewer officials at national and EU levels, are devoted to the principle that systemic stability requires system-level actions and coordination across various authorities, each with its own responsibilities and "turf". Nevertheless, once a consensus was reached, action and results came quickly.

After the exceptional set of meetings and extensive decentralised consultations in March, the ESRB General Board met on 2 April. It agreed on five topics for accelerated further work intended to result in specific policy proposals or ESRB analyses of key issues. The workstreams were to assemble small groups of experts put forward by the ATC as well as members of the ASC. For each workstream, the General Board would identify immediately a mission with a short timeline for delivery. Deliverables would be presented to the SC under the supervision of the ESRB First-Vice Chair, in close cooperation with the Chairs of the ATC and the ASC. The SC would discuss the deliverables and submit them, if agreeable, to the General Board for discussion and decisions. The ESRB Secretariat would support this process.

The timing was tight. In the event, the workstreams reported to General Board meetings on 6 May, 27 May, and 25 June. Some measures and publications were approved at each of these meetings. The timetable reflected not only the range and difficulty of the work, but also the need to arrive at public statements and recommendations that would command a consensus in the General Board. The complexity of some of the issues and the sometimes conflicting interests of Member States often required extended discussions and indeed negotiations to arrive at wordings that were generally acceptable. Leadership from the top was essential and was forthcoming.

The selected priority areas and corresponding workstreams were as follows:

- implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy;
- market illiquidity and implications for asset managers and insurers;
- impact of procyclical downgrades of bonds on markets and entities across the financial system;
- system-wide restraints on dividend payments, share buybacks and other payouts;
- liquidity risks arising from margin calls.

1 See ESRB (2020a).

2 See ECB (2020a).

3 See ECB (2020b).

The initial mandates of these workstreams were detailed, and they were generally followed closely. The work was intensive, with innumerable teleconferences. The resulting output was remarkable, due to sustained effort by staff and workstream members and careful, sustained guidance from the top. I now paraphrase the individual mandates as stated at the outset and set out the work produced by the five groups, with some commentary. Note that workstreams 3 and 4 were chaired by members of the ASC, while the other three workstreams were chaired by national central bank officials.

1 Implications of guarantee schemes and other support fiscal measures on the financial system

Unprecedented national fiscal measures are intended to mitigate the financial impact of the fight against Covid-19 on the real economy, and indirectly also on the financial sector. These include postponements of payments to banks (public moratoria), state guarantees to incentivise lending, and public subsidies (state aid). Understanding their impact and effectiveness is essential to foresee future strains on the financial sector and the risk that the financial sector will deepen the crisis through pro-cyclical behaviour: e.g., a steep increase in credit loss provisions and non-performing exposures; or failures of major financial institutions.

The tasks of this workstream were to examine financial stability risks in light of these fiscal measures and to propose measures that might mitigate these risks. It was to analyse:

- implications of the various national guarantee schemes for lending at both the national and European level. This included the cross-sectoral and cross-country implications – intended and unintended – of national guarantee schemes;
- the capacity of the schemes to ensure that a credit crunch is avoided;
- the impact on solvency and viability of banks/insurers/other financial institutions, in particular those with high non-performing loan (NPL) ratios prior to the Covid-19 crisis, also looking at cross-sectoral spillovers;
- the impact of the prudential and accounting treatment of defaults on capital ratios;
- the impact on banks' and insurers' sovereign exposures from the increase in public indebtedness and hence debt sustainability;
- the impact of state guarantees on risk weights and capital ratios;
- possible cooperation and coordination among authorities during the crisis regarding the recovery or resolution of unviable institutions.

Deliverables included:

- an assessment of the diversity of national support schemes and the implications thereof for (i) the resilience of national financial sectors and their ability to provide credit and (ii) for the functioning of the Single Market (e.g. if lending is channeled to markets with the strongest public support for borrowers or differences in the level of fiscal support distort competition among financial services providers);
- identification of areas where EU-wide coordination by the ESRB would enhance the ESRB member authorities' ability to cope with cross-border and cross-sectoral issues;
- possible communications to be issued either by the ESRB or in coordination with the ESRB member institutions; possible informal statements to be transmitted to stakeholders; and possible ESRB warnings and recommendations.

Note here the emphasis on EU-wide coordination and on the defense of the Single Market. Both themes recur in other areas: for example, the work on system-wide restrictions on bank and insurance corporation payouts.

The resulting output of this group included a Recommendation of the ESRB on monitoring the financial stability implications of debt moratoria, and public guarantee schemes and other measures of a fiscal nature taken to protect the real economy in response to the Covid-19 pandemic (ESRB/2020/8).[4] This monitoring was effected by means of several detailed templates produced by the group. The ESRB also issued a letter to governments on the financial stability impact of the national guarantee schemes and other fiscal measures.[5]

2 Market illiquidity and implications for asset managers and insurers

The sharp drop in asset prices associated with the pandemic and measures to fight it caused large-scale redemptions in the funds and insurance sectors, while financial markets were becoming less liquid. The growing mismatch between redemption possibilities for investors and liquidity of assets increases the risk of further asset price falls, as asset managers and insurers may be forced to engage in (fire) sales. This could lead to contagion through losses on the same or correlated assets, which would cause financial instability. Fund managers typically have a range of tools to deal with a wave of redemptions, including swing pricing and redemption gates, although their availability differs across EU jurisdictions. In the insurance sector such tools are typically not available. The tasks of this workstream was to examine financial stability risks stemming from mismatches between asset liquidity and redemptions and to propose measures that could mitigate these risks. It was to analyse:

- trends in the liquidity of different types of assets held by funds and insurers;
- redemption trends in the funds and insurance sectors as well as possible spillovers from the investment fund sector to the insurance or pension fund sector;
- implications for market liquidity;
- ways in which risks to financial stability could be mitigated. This could include assessing costs and benefits of national authorities suspending redemptions in investment funds and insurance products in the public interest as well as measures beyond the remit of (macro)prudential authorities, such as central banks acting as "market-maker of last resort";
- possible alternative tools in the insurance sector, in the absence of macroprudential tools to address liquidity risks;
- possible proposals for regulatory reform that could be implemented urgently.

Deliverables included:

- assessment of the possible future evolution of liquidity of main financial assets held by funds and insurers and their likely resilience to redemption requests;
- identification of areas where EU-wide coordination by the ESRB would enhance the ESRB member authorities' ability to cope with cross-border and cross-sectoral issues;
- possible communications to be issued either by the ESRB or in coordination with the ESRB member institutions;
- possible informal statements to be transmitted to stakeholders; possible ESRB warnings and recommendations.

Here again, the stress on EU-wide coordination is notable. This indeed recurs in the mandate for all five workstreams. The ESRB was very conscious of its unique role in promoting such coordination in the macroprudential space.

The work of this group resulted in an ESRB Recommendation on liquidity risks in investment funds (ESRB/2020/4), with a public statement on the use of liquidity management tools, and a letter to EIOPA on liquidity risks in the insurance sector.[6] Both EIOPA and ESMA responded with public statements. Workstreams 2 and 3 jointly produced an "issues note" analyzing liquidity in the corporate bond and commercial paper markets and the procyclical impact of downgrades, with implications for asset managers and insurers.[7]

3 Procyclical impact of bond downgrades on markets and financial institutions

The economic shock of the fight against the pandemic could be amplified by large-scale downgrades of bonds (including securitised debt instruments). As the implications of the economic shutdown become apparent, many BBB-rated entities could lose their investment grade status. This would render them ineligible for many portfolios, including those that track investment grade indices and some exchange-traded funds (ETFs). It would also render them ineligible for the ECB's Corporate Sector Purchase Programme (CSPP). This would have implications for the refinancing costs for firms and the use of credit lines of banks and could increase the scale of insolvencies and job losses. Downgrades could affect financial institutions with large exposures to such assets, possibly resulting in systemically relevant failures or reduced lending capacity.

This workstream examined the implications for the financial system from a systemic point of view, notably analysing:

- new issuance of investment grade bonds;
- the volume of investment grade bonds that might be subject to downgrades, which entities hold them, and the impact and degree of implied portfolio rebalancing;

4 See ESRB (2020b).
5 See ESRB (2020c).
6 See ESRB (2020d).
7 See ESRB (2020e).

- expectations of rating agency actions;

- the borrowing needs of marginal investment grade or downgraded issuers who may struggle to refinance themselves in the bond market and would need to turn to banks;

- the likely scale of insolvencies of highly leveraged companies and of resulting losses to lenders;

- functioning of the market for high-yield (speculative) bonds, its capacity to absorb "fallen angels" without disruption;

- measures to mitigate risks to financial stability, e.g. ways to counteract mechanical adverse widespread effects of rating downgrades, noting measures beyond the remit of (macro)prudential authorities such as flexibility in the collateral eligibility for standard central bank operations or special purchase programmes.

Deliverables included:

- assessment of the possible future evolution of downgrades and their direct and indirect implications for the financial sector;

- identification of areas where EU-wide coordination by the ESRB would enhance member authorities' ability to cope with cross-border and cross-sectoral issues;

- possible communications to be issued either by the ESRB or in coordination with ESRB member institutions; possible informal statements to be transmitted to stakeholders; possible ESRB warnings and recommendations.

In addition to the issues note described above (joint with Workstream 2), this group (with substantial help from the ECB staff) executed a system-wide scenario analysis of large-scale corporate bond downgrades.[8] This was the first such top-down, aggregate assessment of the possible effects of a wave of downgrades and involved considerable methodological innovation as well as assembly of data from a range of different databases. Moreover, following extended discussions, the General Board agreed to send a letter to the European Commission and ESMA on the potential impact of large-scale downgrades by credit rating agencies, proposing that the Commission could, in cooperation with ESMA, revisit the role of contractual references to ratings in investment mandates and prospectus of funds and assess the transparency of rating agency methodologies.[9]

4 System-wide restraints on dividend payments, share buybacks and other payouts

Several ESRB member institutions (EBA, EIOPA, ECB/SSM[10]) had already encouraged banks and insurance corporations in the European Union to restrain voluntary payouts (e.g. dividends, bonuses, share buybacks aimed at remunerating shareholders). Such measures can enhance the resilience of the financial sector, strengthening its capacity to lend to the real economy and reducing the risk of failures of financial institutions and needs for public intervention. The ESRB was to consider further supporting these welcome developments by:

- promoting uniform adoption by all National Supervisory Authorities (NSAs) of measures recommended by ESAs;

- making the case for global or regional arrangements beyond the EU going in the same direction;

- considering pros and cons of the extension of the same recommendation to other financial corporations and possibly to non-financial corporations;

- investigating the impact of the recommendations on the functioning of the Single Market, including issues of the payment of dividends of subsidiaries to the groups;

- linking future (i.e., beyond 2020) limitations on payouts to possible recapitalisation; need for legislative action vs. voluntary requests.

Deliverables included:

- assessment of pay-out trends in the financial and non-financial corporate sector and their implications for the resilience of the financial sector and its ability to provide credit to the real economy;

- identification of areas where EU-wide coordination by the ESRB would enhance the ESRB member authorities' ability to cope with cross-border and cross-sectoral issues;

- possible communications to be issued either by the ESRB or in coordination with the ESRB member institutions; possible informal statements to be transmitted to stakeholders; possible ESRB warnings and recommendations.

This workstream did indeed deliver a Recommendation, addressed by the General Board to the competent authorities, on the restriction of distributions during the Covid-19 crisis, applicable until the end of 2020.[11] It also wrote an explanatory report published by ESRB.[12] The work here was exceptionally difficult because of perceived conflicts of the interests of different Member States, in particular home and host countries of major cross-border banks, and the need to defend the Single Market. The ESAs, too, had their own views (some having already taken relevant measures), and microprudential perspectives sometimes differed from macroprudential, system-wide views. The resulting Recommendation is a tribute to the virtues of compromise and recognition of system-wide interests.

5 Liquidity risks arising from margin calls

The crisis resulted in significant margin calls on derivative positions, with major implications for the liquidity of counterparties and their funding needs, and possibly their solvency. One objective of the post-GFC reforms was to reduce the buildup of uncollateralised exposures from derivative transactions through the introduction of mandatory clearing for OTC derivatives and daily margining in cleared (and uncleared) transactions. As a result, more and more products are cleared by central counterparties (CCPs), which have greatly contributed to reducing overall counterparty credit risk as well as overall liquidity needs in liaison with netting benefits. In times of financial strain, however, initial margin calls tend to rise as CCPs need to protect against the risk of counterparty default and the likely increase of the cost of managing such a default. Variation margins rise as they reflect market moves. Initial and additional margin requirements might become more stringent, along with the possible worsening of credit quality of members and their clients. These tensions may be exacerbated for clearing members who have multi-currency activities in various CCPs, whether in Europe or offshore, and who therefore face multiple sources of increased liquidity risk. There might also be repercussions for funding markets and a balance sheet impact from asset encumbrance in terms of liquidity and solvency requirements.

This workstream analysed:

- the amount and concentration of initial and variation margin on counterparties in cleared and non-cleared transactions, including the knock-on effects on clients clearing via clearing members and to what extent membership requirements and access policies might create additional risks;
- how margins are funded and the implications of encumbering assets held in initial margin;
- whether the clearing system and antiprocyclicality measures functioned as intended or whether CCPs or clearing members acted in ways that amplified liquidity risk;
- whether recent events revealed fault lines that had not been addressed by the post-GFC reforms;
- ways to mitigate risks to financial stability that could emerge from large margin calls.

Deliverables included

- assessment of the scale of current and possible future margin calls and their impact on market participants and on the real economy;
- identification of areas where EU-wide coordination by the ESRB would enhance the ESRB member authorities' ability to cope with cross-border and cross-sectoral issues;
- possible communications to be issued either by the ESRB or in coordination with the ESRB member institutions; possible informal statements to be transmitted to stakeholders;
- possible ESRB warnings and recommendations.

The main output of this workstream was also an ESRB Recommendation, in this case on liquidity risks arising from margin calls (ESRB/2020/6)[13], and it was supplemented by another report published by ESRB.[14] The Recommendation had four separate components, and the work reflects a high level of technical expertise in the working group.

Conclusion

It should be evident that the ESRB – its leadership, the General Board, its secretariat and committees – addressed the systemic risks created by the covid-19 crisis with exceptional effort and wide-ranging results. I believe they have notably enhanced the stability of the financial system and will continue to do so. The examples here of policy coordination across diverse constituencies are inspiring. One may hope that this is not just a short-run response to crisis, and that this coordination – essential for systemic stability – will continue in normal times.

8 See ESRB (2020f).
9 See ESRB (2020g).
10 Single Supervisory Mechanism.
11 See ESRB (2020h).
12 See ESRB (2020i).
13 See ESRB (2020j).
14 See ESRB (2020k).

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