EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Sabine Lautenschläger
Vice-Chair of the Supervisory Board
Member of the Executive Board

Pro-cyclicality and interconnectedness in the financial sector – the European perspective

Joint BoE-HKMA-IMF Conference

November 8-9, 2017, Washington DC

Agenda

1	Introduction
2	Post-crisis reforms and developments in the banking sector
3	Changing structure of the euro area financial sector
4	The non-bank sector and pro-cyclicality
5	Conclusion

- The financial crisis has highlighted several weaknesses and features in the financial system:
  i. a build-up of excessive leverage in expansionary phases
  ii. a higher degree of interconnectedness than perceived
  iii. pro-cyclical effects of risk-sensitive regulation
  iv. pro-cyclical effects of accounting rules

- Pro-cyclicality and interconnectedness were underestimated which led to a build up of systemic risk

- What about today?

Agenda

Significant progress in regulatory reforms that address pro-cyclicality and interconnectedness

- **Increased level of capital and liquidity** improve overall resilience of banking system
- **Macroprudential buffer framework:** addresses various dimensions of systemic risk; possibility to draw down or release when economic conditions deteriorate
- **Leverage ratio:** restricts the build-up of excessive leverage
- **Large exposure restrictions:** target exposure concentrations or excessive interconnectedness among financial institutions
- **Targeted macroprudential tools:** address excessive credit flows, (e.g. in real estate sector) via borrower and capital-based measures
- **Broader competences** for public authorities

Resolution frameworks also mitigate pro-cyclicality and interconnectedness

	Globally	Europe
Framework	FSB Key Attributes	BRRD and SRM Regulation
Cooperation	Crisis Management Groups for all G-SIBs	• Banking Union • Colleges + CMGs
Loss absorbing capacity	TLAC for G-SIBs	MREL for all banks (for G-SIBs TLAC consistent)
Reducing interconnections	• Disincentives for cross-holdings of TLAC • Internal TLAC • MPE vs. SPE • Holding company/ subsidiarization	• Disincentives for cross-holdings of intra-group MREL are foreseen • Internal MREL • MPE vs. SPE • IPU proposal

What remains to be done?

Globally:

- Finalize Basel III framework to restore confidence in risk-based capital ratios while upholding international cooperation
- Ensure a consistent implementation across countries
- Monitor and assess the effects of the reforms

In Europe:

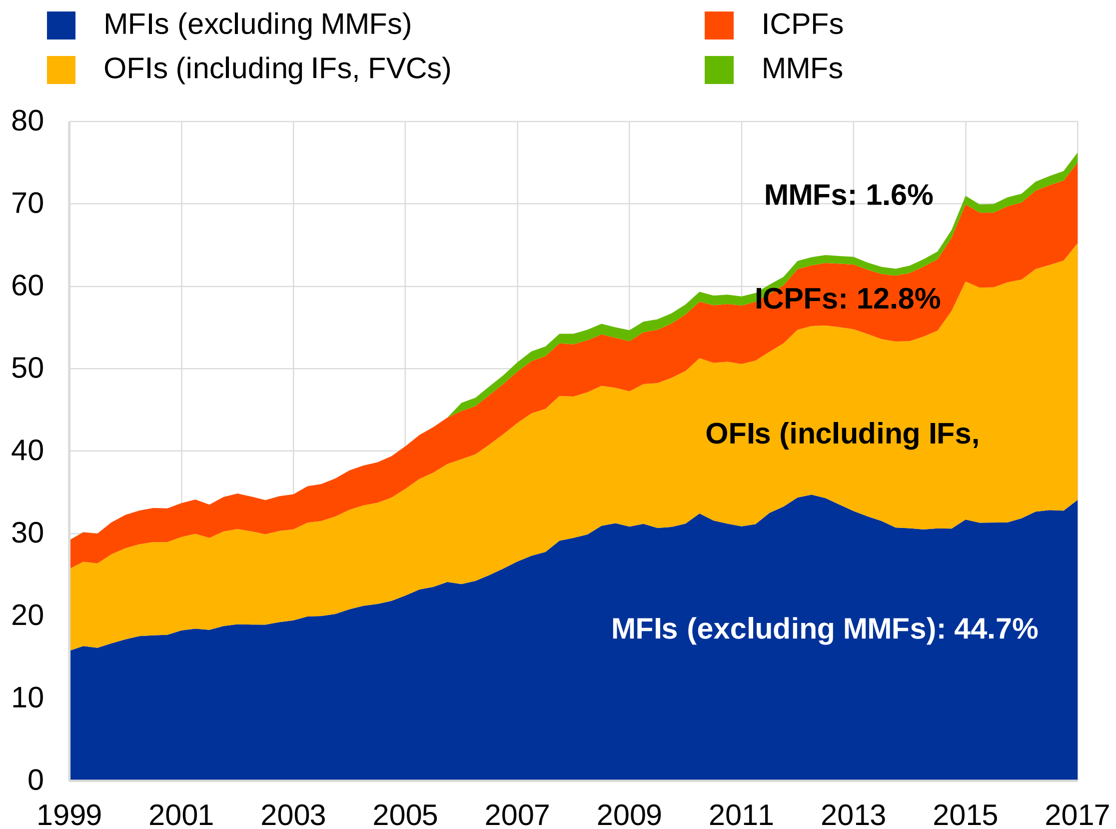
- Make use of the on-going legislative review to ensure that most effective tools are available to micro- & macroprudential authorities
- Promote further harmonisation and consistent regulation across different sectors to avoid regulatory arbitrage

Agenda

Increasing share of non-bank entities in the euro area financial sector

Composition of the euro area financial sector

(Q1 1999 – Q1 2017; total assets; EUR trillions)



Sources: ECB (EAA, MFI BSI statistics) and ECB calculations.

Notes: MFIs (excluding MMFs) refer to credit institutions resident in the euro area, including branches and subsidiaries whose headquarters are located outside the euro area, and the Eurosystem. OFIs refer to non-monetary financial corporations excluding ICPFs (i.e. non-MMF investment funds, FVCs and the remaining OFIs are included). Non-financial assets are excluded.

Agenda

1. Introduction
2. Post-crisis reforms in the banking sector
3. Changing structure of the euro area financial sector
4. **The non-bank sector and pro-cyclicality**
5. Conclusion

Pro-cyclicality at transaction level

- Collateral plays an increasingly important role in the post-crisis financial system
- Margin calls in securities financing transactions and derivative markets can amplify funding stress and deleveraging
- …including **risks** that **cut across sectors** (banks and non-banks)

Policy measures aimed at limiting pro-cyclical effects

- FSF 2009: “Authorities should use quantitative indicators and/or constraints on leverage and margins as macroprudential tools for supervisory purposes”
- FSB 2015: framework for haircuts on non-centrally cleared securities financing transactions (SFTs):
  - qualitative standards for methodologies for haircuts
  - numerical haircut floors for non-centrally cleared SFTs where financing against collateral other than government securities is provided to non-banks
- EMIR requires market players to use anti-procyclicality tools
- Potential role for macroprudential authorities to mitigate pro-cyclical effects?

Pro-cyclicality in the asset management sector

- funds reduce exposures during downturns or engage in asset sales triggered by a fall in asset prices
- leveraged funds sell assets due to higher financing costs

Global and European policy initiatives

- FSB policy recommendations on structural vulnerabilities in the asset management sector aim to reduce liquidity mismatches
  - Potential macroprudential role of authorities in extraordinary circumstances (e.g. suspension of redemptions)
- The ESRB is developing recommendations that are addressed to funds and asset managers
  - ESRB is analysing systemic risks posed by liquidity mismatch and leverage in the types of investment funds exposed to these risks

Agenda

1	Introduction
2	Post-crisis reforms in the banking sector
3	Changing structure of the euro area financial sector
4	Pro-cyclicality and the non-bank sector
5	Conclusion

Conclusion

In the banking sector, progress has been made to tackle pro-cyclicality and interconnectedness…

- ... but effects of the reforms need to be monitored and assessed to also close potential gaps in regulation

Developments in the non-bank sector need to be monitored...

- … and current frameworks further developed, also foreseeing a role for macroprudential authorities

As the financial system is global, there is a **need to address** weaknesses, including pro-cyclicality and interconnectedness also **on a global basis**