# 3 EURO AREA FINANCIAL INSTITUTIONS

*Euro area financial institutions have continued to make steady progress in tackling legacy issues from the financial crisis, while adapting to an evolving regulatory and prudential environment.* ***Bank balance sheets*** *have been strengthened further, with a clear shift towards capital increases in 2014, from deleveraging and de-risking in previous years. While some asset quality concerns remain, the pace of deterioration has slowed considerably. The comprehensive assessment has brought much-needed transparency and confirms that a large majority of the most significant euro area banks is well equipped to withstand a severe economic downturn.*[1]

*Notwithstanding these efforts to strengthen balance sheets, a combination of cyclical and structural headwinds has implied weak* ***profitability*** *in many parts of the euro area banking sector. In particular, elevated loan loss provisions and subdued revenues remain a drag on profits in an environment of low growth and flat yield curves. While cyclical headwinds should abate as economic conditions improve, there is a clear need to continue to adapt bank strategies and business models so as to sustainably improve profitability in a post-crisis environment, notably to foster internal capital generation. In this context, bank lending activity remains subdued – with loans to non-financial corporations developing particularly sluggishly, mainly on account of anaemic credit demand and persistent fragmentation of credit conditions. Over time, further progress in removing impediments to the supply of bank credit – also including disposals of non-performing loans – should help improve credit conditions, as should, in particular, the ECB's targeted measures to improve access to finance essential for economic growth.*

*Not only banks, but also* ***insurers****, for whom a prolonged period of low yields remains a key concern, have been adapting their business models to the prevailing macro-financial environment. While low yields have placed pressure on earnings in the latter sector, the financial performance and capital positions of large euro area insurers have remained sound.*

*On the* ***policy*** *front, progress continues apace in the regulatory and prudential domains. In the regulatory field, further advances have been made, in particular, in weakening the links between sovereigns and banks, and in building a more resilient banking sector. Since the publication of the last issue of the Financial Stability Review (FSR), much has been achieved to put in place central elements of an integrated financial framework in Europe, especially the euro area, namely (i) the Single Supervisory Mechanism, (ii) a common resolution framework, (iii) a Single Resolution Mechanism and (iv) harmonised deposit insurance. In line with a new and reinforced prudential mandate, a number of euro area Member States have announced specific macro-prudential measures. These include systemic risk measures in order to mitigate systemic risks originating from the significant size, high concentration and interconnectedness in their banking sectors. Different types of property-related measures have been adopted as well, with the aim of addressing unfavourable developments in the property market (see Section 3.3 for a description of measures taken).*

## 3.1 BALANCE SHEET REPAIR CONTINUES, BUT WEAK PROFITABILITY PERSISTS IN THE EURO AREA BANKING SECTOR

### FINANCIAL CONDITION OF EURO AREA BANKS

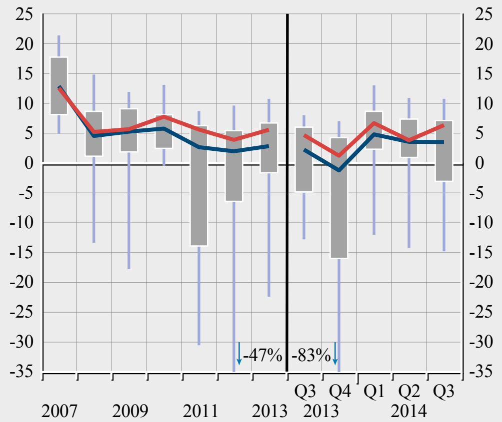
***Bank profitability remains under pressure…***

Euro area banks' **profitability** remained weak in the first three quarters of 2014, given a confluence of both cyclical and structural factors. In the third quarter of 2014, the median return on equity (ROE) of significant banking groups (SBGs) in the euro area remained broadly unchanged from three months earlier, at around 4%, and showed only a slight improvement on a year-on-year basis (see Chart 3.1). Elevated loan loss provisions remained the most important cyclical drag on bank

1 Given the broad nature of the comprehensive assessment, including a bottom-up stress-test exercise, and the forthcoming stress test by EIOPA on insurers, sensitivity analyses for financial institutions are not presented in this issue of the FSR.

**Chart 3.1 Euro area banks' return on equity**

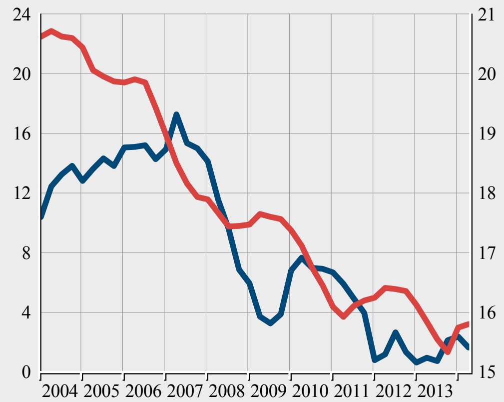
(2007 – Q3 2014; percentages; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report annual financial statements and on data on a sub-set of those banks that report on a quarterly basis.

**Chart 3.2 Return on equity and leverage for large euro area banks**

(Q1 2004 – Q2 2014; median values for SBGs)




Sources: Bloomberg and ECB calculations.
Note: Based on publicly available data on a sub-sample of listed SBGs that report quarterly financial statements.

performance, even if these provisions have fallen somewhat over the last half year. Furthermore, banks are also struggling to boost revenues in an environment of low growth and flat yield curves. In addition to cyclical factors, one-off factors also affected some banks, mainly in the form of large non-recurring expenses related to litigation charges or goodwill write-downs that depressed profits.

*… given a combination of cyclical and structural headwinds…*

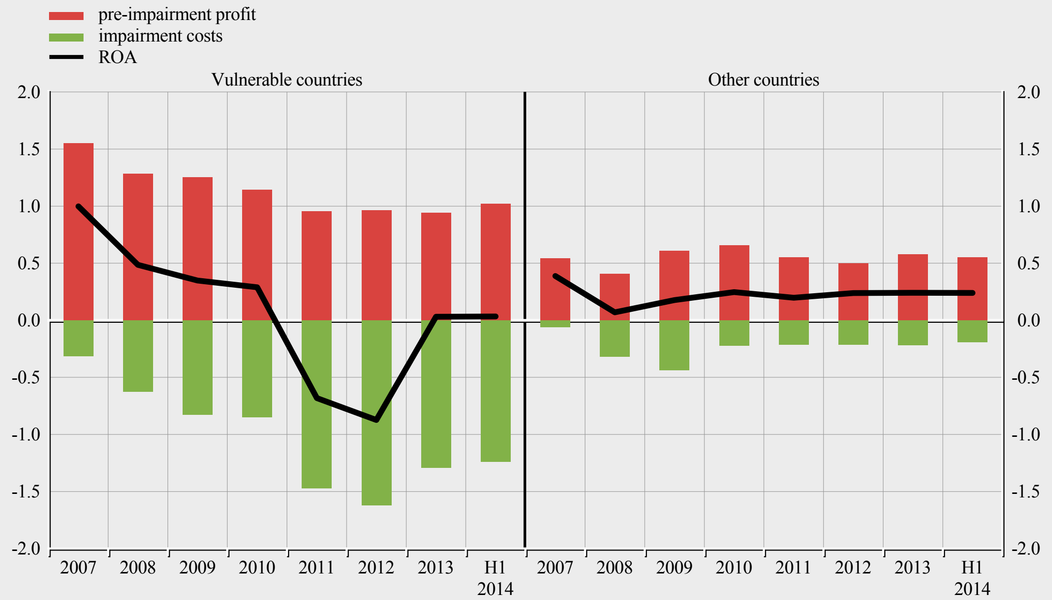
At the same time, the de-risking and deleveraging of bank balance sheets (see Chart 3.2) as well as some structural factors – such as strong domestic competition or remaining cost inefficiencies in some parts of the euro area banking sector – have also contributed to lower profitability. This combination of both cyclical and structural headwinds has pushed banks' ROE well below their cost of equity in the past few years. As the impact of cyclical factors eventually fades away, any weak structural profitability remaining could limit banks' internal capital generation and provide incentives for banks to take on more risks. Moreover, for some banks, persistently weak profitability also raises questions about the viability of their business models. In this respect, while a number of euro area banks have made progress in restructuring their operations since the start of the crisis, driven by continued pressure to contain costs and reduce non-core activities, the advances have been uneven across different parts of the banking sector. Therefore, further measures need to be taken in parts of the banking sector to adapt business models to new realities, for instance, by refocusing activities on profitable core business, diversifying income sources or further improving cost efficiency.

*… due to elevated credit risk costs and compressed interest margins…*

Low profitability remains a concern for most euro area banks, although the main drivers have differed somewhat across banks and countries in recent years. In countries that experienced a recession in the last few years and where economic recovery remains weak, low or negative bank profitability has been driven primarily by high loan loss provisions (see Chart 3.3). More generally, over the past few years, pre-impairment operating profits remained rather subdued, or showed a decline, on account of a combination of narrowing net interest margins and weak loan volume

**Chart 3.3 Euro area banks' return on assets, pre-impairment profits and impairment costs in vulnerable and other countries**

(2007 – H1 2014; percentage of total assets; median values for SBGs)



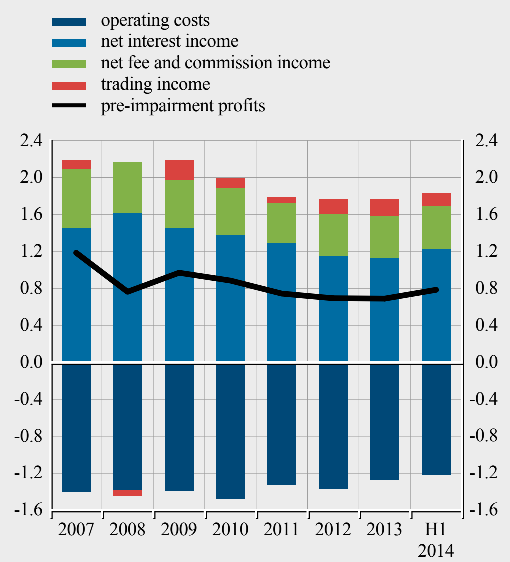

Source: SNL Financial.
Notes: Based on publicly available data on SBGs that report on a semi-annual basis. Two-period averages for the first half of 2014. "Vulnerable countries" refer to Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

growth. For banks in vulnerable countries, net interest income had been negatively affected by higher funding costs as a consequence of the sovereign crisis, while interest margins in some core countries (notably in Germany) have been structurally low for a long time, mainly on account of intense bank competition, a situation that has recently also been exacerbated by low interest rates.

More recently, however, euro area banks' operating performance showed signs of a moderate improvement – with median pre-impairment profits for SBGs increasing somewhat in the first half of 2014 (see Chart 3.4). This mainly reflected a modest overall increase in net interest income as average funding costs declined more than asset yields (see Chart 3.5), albeit with significant cross-country heterogeneity. In particular, many banks from vulnerable countries recorded an improvement – contrasting with flat or even declining patterns for a number of banks in other countries.

**Chart 3.4 Euro area banks' pre-impairment profits and their main components**

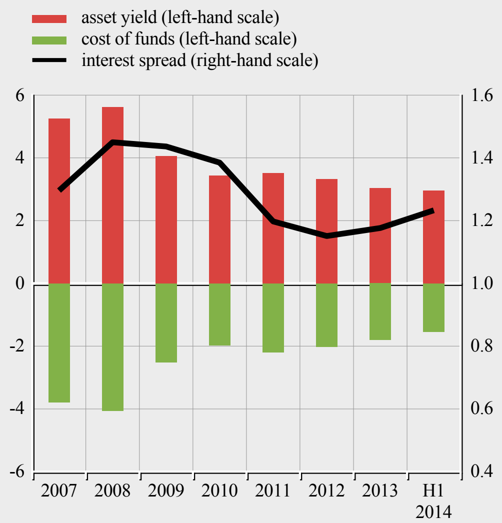
(2007 – H1 2014; percentage of total assets; median values for SBGs)




Source: SNL Financial.
Notes: Based on publicly available data on SBGs that report on a semi-annual basis. Two-period averages for the first half of 2014.

**Chart 3.5 Interest spread and its components for significant banking groups in the euro area**

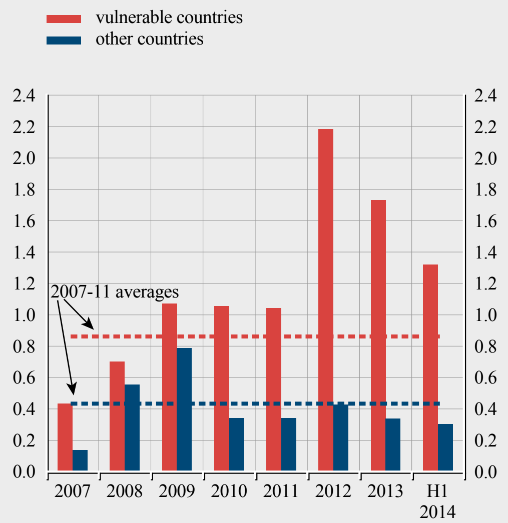
(2007 – H1 2014; percentages; median values for SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report on a semi-annual basis.

**Chart 3.6 Loan loss provisions of banks in vulnerable and other euro area countries**

(2007 – H1 2014; percentage of total loans; median values)




Source: SNL Financial.
Notes: Based on publicly available data on SBGs that report on a semi-annual basis. "Vulnerable countries" refer to Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

These cross-country differences in funding costs mainly reflect the marked fall in sovereign yields in vulnerable countries. In these countries, a median decline of 21% in interest costs in the first half of 2014 – resulting from a spillover of lower sovereign yields to both deposit and wholesale funding costs – contrasted with a more moderate decrease in interest costs for banks in other countries (median decline of 9%). Mirroring these patterns, banks in vulnerable countries registered a median increase of 4% in net interest income in the first half of 2014, as compared with a year earlier, compared with a median increase of 2% for banks in other countries.

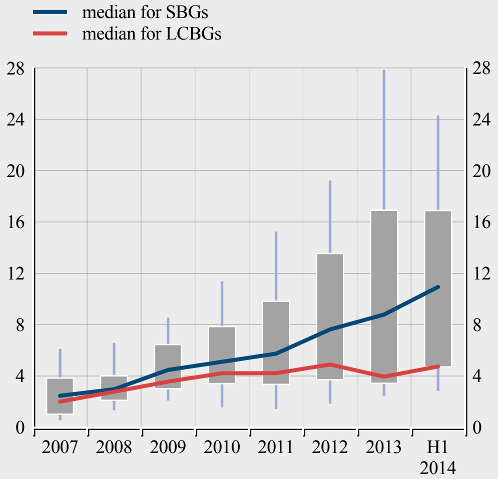
At the same time, non-interest income decreased slightly in the first half of 2014 due to lower trading income, while fee and commission income remained stable. In the same period operating costs, expressed as a percentage of total assets, decreased somewhat on average reflecting banks' continued efforts to cut costs (see Chart 3.4). That said, the progress in improving cost efficiency remains uneven across banks with more than one-fifth of SBGs maintaining cost-to-income ratios above 70%, suggesting that for several banks there is scope for further cost containment.

*… with high impairment costs affecting mainly banks in vulnerable countries…*

Despite some easing of cyclical headwinds, banks' financial results have continued to be heavily affected by high impairment costs, albeit to a lesser extent than six months earlier. Stark differences in impairment costs across banks persisted, with smaller banks from vulnerable countries bearing much of the negative impact on results. In the first half of 2014, the median value of loan loss provisions (the bulk of impairment costs) for SBGs in vulnerable countries was still above the average over the five years preceding the sovereign debt crisis (2007-11). By contrast, average loan loss provisions for banks in other countries remained at moderate levels (see Chart 3.6). Furthermore, additional provisioning needs identified by the asset quality review (AQR) are likely to be recognised mostly in banks' fourth-quarter or full-year 2014 results.

**Chart 3.7 Impaired loan ratios of euro area banks**

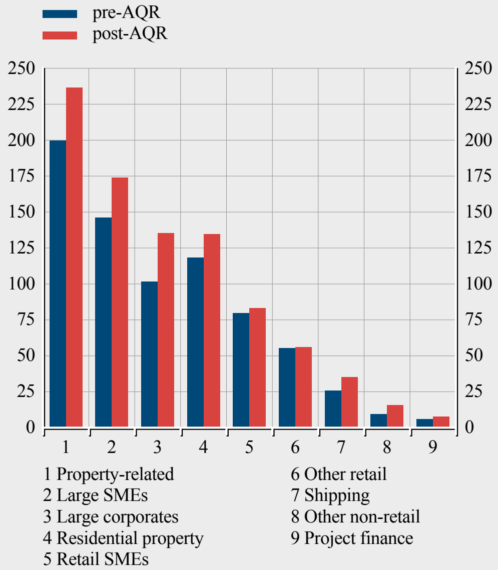
(2007 – H1 2014; percentages; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report semi-annual financial statements.

**Chart 3.8 Impact of the AQR on non-performing exposures by asset class**

(EUR billions)




Source: ECB.
Note: The AQR-related changes reflect the impact of the application of the EBA's simplified NPE approach and the credit file review.

*… on account of a further increase in non-performing loans…*

Divergent reported **asset quality** trends across banks continued into the first half of 2014 (see Chart 3.7), with banks in vulnerable countries experiencing a further deterioration, albeit at a slowing rate. This development was mainly linked to weak macroeconomic conditions in these countries, although some of the increase in non-performing loan (NPL) ratios may also have been related to a reclassification of restructured loans in anticipation of the future implementation of harmonised European Banking Authority (EBA) standards for NPLs.

Moreover, for the 130 banks subject to the comprehensive assessment, the AQR resulted in an increase of €136 billion, or 18%, in non-performing exposures (NPEs) with respect to figures reported for end-2013 (see also Box 4). By asset class, AQR-related increases in NPEs in absolute terms were largest for property-related and large corporate exposures, followed by large SMEs (see Chart 3.8).

Looking ahead, banks with a large stock of NPLs on their balance sheets still face the challenge of dealing with their problem assets, even if banks in some vulnerable countries have made some progress in writing off or disposing of bad loans (over and above the transfer of assets to bad banks/asset management companies). Further significant progress in this area is all the more important as a slow resolution of NPLs could limit banks' potential for new (profitable) lending.

*… while coverage ratios remained broadly stable*

Despite higher provisioning by a number of banks, **coverage** of impaired (non-performing) loans by reserves remained broadly stable in the first half of 2014, with the median coverage ratio for SBGs standing at 54% at end-June (see Chart 3.9). Loan loss reserves of large and complex banking groups (LCBGs) remained considerably higher than those of smaller SBGs, with the median value for the largest banks reaching 61% in mid-2014.

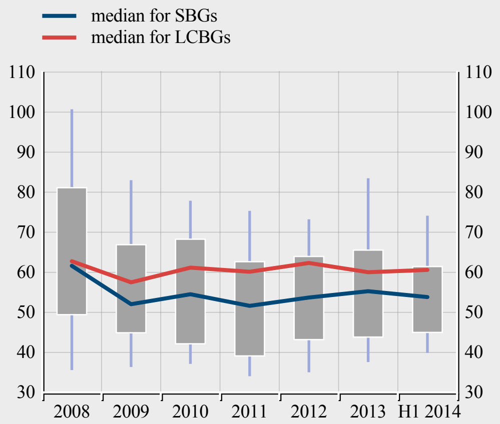
Overall, following the ECB's comprehensive assessment exercise, long-lingering concerns about the asset and collateral valuation of significant banks in the euro area, NPL recognition as well as provisioning practices have largely dissipated. While the asset quality review, in the case of some banks, has led to higher provisions and reported NPLs in the short term, it should help strengthen confidence in the sector.

*Banks improved risk-weighted capital ratios further…*

While banks' subdued earnings performance continued to limit internal capital generation, a steady across-the-board increase in euro area banks' **risk-weighted capital ratios** continued in the first half of 2014. Core Tier 1 (CT1) capital ratios increased only slightly in comparison with the levels at end-2013, and even decreased for LCBGs, given the one-off increase in risk-weighted assets following the implementation of the Capital Requirements Directive IV (CRD IV) (see left-hand panel of Chart 3.10). This affected both credit and counterparty risk-related and market risk-related risk-weighted assets due to, among other things, the new calculation of risk-weighted assets for the credit valuation adjustment (CVA) and the inclusion of former capital deduction items for higher risk securitisation positions.

**Chart 3.9 Coverage ratios of euro area banks**

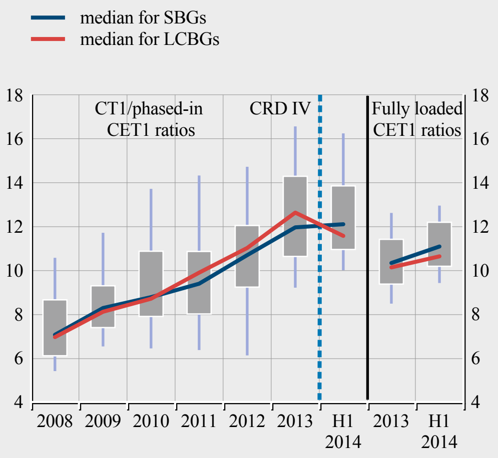
(2008 – H1 2014; loan loss reserves as a percentage of impaired loans; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report annual financial statements and on data on a sub-set of those banks that report at least on a semi-annual basis.

**Chart 3.10 Core Tier 1 (CT1)/common equity Tier 1 (CET1) capital ratios of euro area banks**

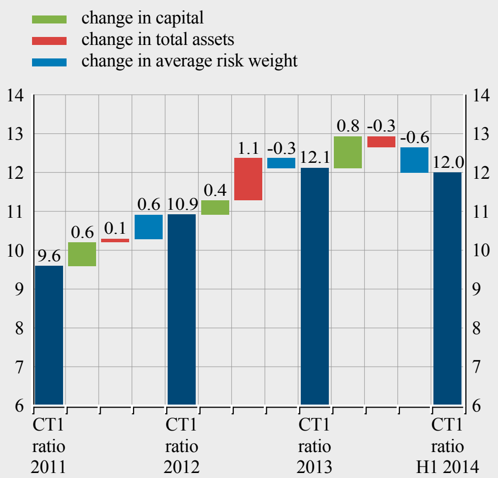
(2008 – H1 2014; percentages; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report annual financial statements and on data on a sub-set of those banks that report on a semi-annual basis.

**Chart 3.11 Decomposition of changes in euro area banks' aggregate Core Tier 1 capital ratio**

(2011 – H1 2014; percentages and percentage points)




Sources: SNL Financial and ECB calculations.
Notes: Based on publicly available data for a sample of 65 SBGs that report at least on a semi-annual basis. The increase in the average risk weight in the first half of 2014 was mostly due to the implementation of CRD IV.

Based on a fully loaded common equity Tier 1 (CET1) definition, the median CET 1 ratio for banks participating in the comprehensive assessment exercise was 11.1% at 1 January 2014 (pre-AQR). Public disclosures by a sub-sample of SBGs suggest that fully loaded CET1 ratios may have improved further in the first six months of this year, with the median ratio for 45 reporting SBGs rising by nearly 80 basis points (see right-hand panel of Chart 3.10).

*… mainly through capital increases…*

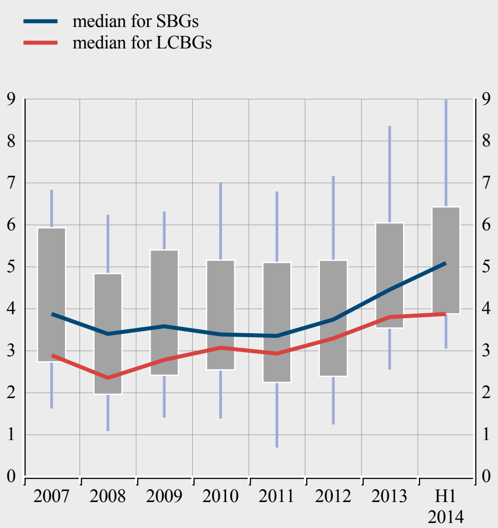
A decomposition of changes in banks' aggregate risk-weighted capital ratio over the last two and a half years shows a shift towards capital increases in the first half of 2014 (see Chart 3.11). Recent increases in CET1 capital have mainly resulted from a further expansion of equity capital, which has amounted to over €50 billion for SBGs since end-2013. Furthermore, some banks completed or announced capital increases in the third quarter of 2014, partly in preparation for the comprehensive assessment to address capital shortfalls. By contrast, increasing risk-weighted assets contributed to lower capital ratios on account of both increasing average risk weights (due mainly to the implementation of CRD IV) and the reversal of asset deleveraging for a number of banks.

*… while large banks lag behind their global peers in improving leverage ratios*

Thanks to a significant pick-up in banks' equity issuance, euro area SBGs also continued to improve their balance sheet-based **leverage** ratios, with the median ratio of tangible common equity to tangible assets rising to 5.1% in mid-2014, from 4.5% at end-2013 (see Chart 3.12). However, the improvement of leverage ratios was more muted for LCBGs, with some of the largest banks remaining in the lowest quartile of the SBG distribution. In fact, despite recent improvements, large euro area banks continue to lag behind their global peers in terms of their leverage ratios when measured by adjusted tangible equity over adjusted tangible assets on a comparable basis (see Chart 3.13).

**Chart 3.12 Euro area banks' leverage ratios (tangible common equity to tangible assets)**

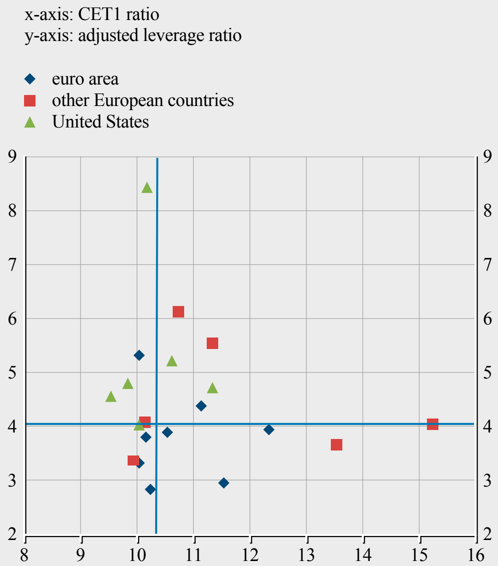
(2007 – H1 2014; percentages; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs, including LCBGs, that report annual financial statements and on data on a sub-set of those banks that report on a semi-annual basis.

**Chart 3.13 CET1 ratio and adjusted leverage ratio for large banks in the euro area, other European countries and the United States**

(H1 2014; percentages)




Sources: Federal Deposit Insurance Corporation and SNL Financial.
Notes: The adjusted leverage ratio is calculated as adjusted tangible common equity to adjusted tangible assets. Horizontal and vertical lines show median values.

**Box 4**

## THE ECB'S COMPREHENSIVE ASSESSMENT EXERCISE

The results of the ECB's comprehensive assessment, a thorough and unprecedented examination of 130 euro area banks, were published on 26 October 2014. This box presents the scope, main findings and conclusions of the comprehensive assessment exercise.

### Scope of the comprehensive assessment

The exercise was undertaken as part of the preparations for the ECB's assumption of supervisory responsibilities on 4 November 2014. The 130 banks participating in the exercise had total assets of €22 trillion at the end of 2013, accounting for more than 80% of total assets of the euro area banking system.

The comprehensive assessment exercise had two components:

- An asset quality review (AQR) of the assets held by banks at end-2013, in the course of which banks' accounting models, policies and practices were checked on the basis of a common methodology[1] and harmonised definitions across all participating countries.

- A constrained bottom-up stress test, in the course of which banks were requested to project the impact of hypothetical baseline and adverse macro-financial scenarios on their balance sheets and income statements.

The results of both components were joined together using a methodology that adjusted the stress-test results to reflect the findings of the AQR,[2] a unique feature of the comprehensive assessment in comparison with similar stress-testing exercises.

Both components of the comprehensive assessment exercise were subject to a rigorous quality assurance process, comprising banks, national supervisors and the ECB, in order to ensure the appropriate degree of conservatism and a level playing field for all participating banks. The adverse macro-financial scenario for the stress test was designed by the European Systemic Risk Board. It captured the most relevant threats to the stability of the EU banking system that were identified in the spring of 2014, including an increase in global bond yields, a deterioration in credit quality, stalling policy reforms that lead to a re-emergence of sovereign risk and a lack of the balance sheet repair necessary to sustain market funding at affordable rates. Overall, these risks still remain relevant to date. The comprehensive assessment was a prudential exercise. By design, its scope did not include some of the macro-prudential risks related to, for example, the interconnectedness of participating banks or second-round effects arising from banks' endogenous response to macro-financial stress.

### Main findings

The comprehensive assessment concluded that most of the euro area banks would be resilient under the adverse macro-financial scenario in spite of a significant depletion of their capital.

1 See *Asset quality review – Phase 2 Manual*, ECB, March 2014.
2 See *Comprehensive assessment stress test manual*, ECB, August 2014.

The Common Equity Tier 1 (CET1) capital of the participating euro area banks would be reduced by €216 billion (see Chart A), €34 billion of which is due to the adjustment made in the course of the AQR, and €182 billion to the losses projected in the adverse scenario of the stress test.[3] In addition, the minimum capital requirements would rise by €47 billion as a result of the increase in risk-weighted assets.

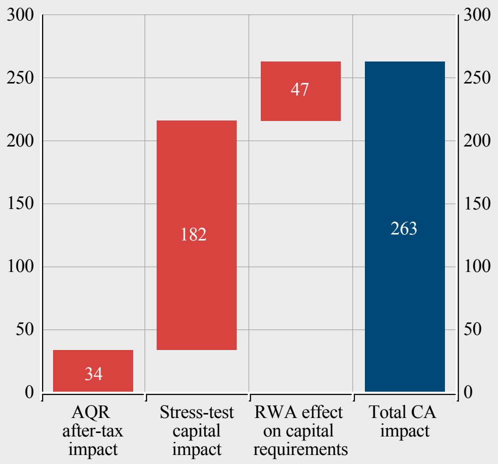
It was found that 25 euro area banks did not have sufficient capital to meet the CET1 capital ratio requirements specified for the comprehensive assessment exercise of 8% for the baseline and 5.5% for the adverse scenario. The total capital shortfall amounts to €24.6 billion prior to mitigating actions taken after the end-2013 reference date.

The AQR concluded that, under the common methodology and harmonised definitions, the non-performing exposures (NPEs) of participating banks should increase by €136 billion, or 18%, with respect to the stock of NPEs reported at the end of 2013. The review of impairment provisions related to both NPEs and other assets found that banks would mark down their assets by a further €43 billion on a pre-tax basis.

The baseline scenario of the stress test entailed an only slight increase in the CET1 capital ratio, reflecting the subdued operating profitability of participating banks. Under the adverse scenario, loan losses would nearly double with respect to the baseline case, and net interest income would contract by about 10%. A somewhat less material contribution to aggregate losses came from

**Chart A Total impact of the adverse scenario of the comprehensive assessment on capital**

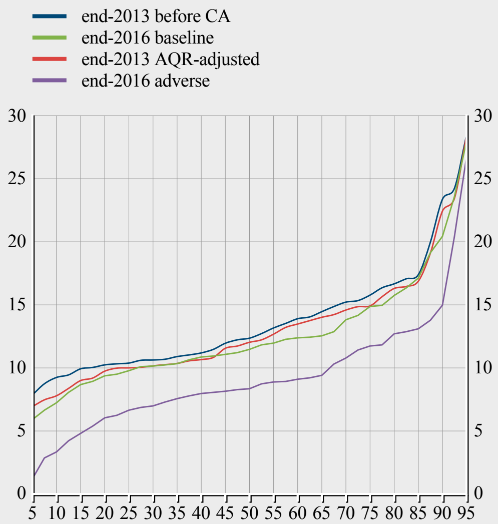
(EUR billions)




Source: ECB.

**Chart B Distribution of the CET1 capital ratios of banks participating in the comprehensive assessment**

(x-axis: percentile of the distribution, y-axis: CET1 capital as a percentage of risk-weighted assets)




Source: ECB.
Note: Distribution censored at 5th and 95th percentile to remove outliers.

3 See *Aggregate report on the comprehensive assessment*, ECB, October 2014.

a downward revaluation of trading assets and sovereign bonds, as well as from non-interest income. Overall, the capital ratio of the median bank would be reduced by around 4 percentage points, to about 8.3% (see Chart B).

### Conclusions

The comprehensive assessment has caused euro area banks to take extensive action that has raised capital and reduced risk to mitigate potential capital shortfalls. In addition to capital measures taken prior to the end-2013 cut-off date of the comprehensive assessment exercise, banks continued to strengthen their balance sheets in 2014 (see Section 3.1 for more details). Twelve of the banks that were found to have a capital shortfall had already covered these shortfalls prior to the end of the exercise. The remaining 13 banks, with a combined capital shortfall of €9.5 billion, are implementing capital plans and are expected to reinforce their capital buffers. The capital actions should be completed within six months of the end of the assessment[4] if shortfalls result from the AQR or the baseline scenario, or within nine months in case of shortfalls resulting from the adverse scenario.

From a forward-looking perspective, the results of the comprehensive assessment represent a major step towards balance sheet repair and strengthening the euro area banking sector, which in turn is key to enable the sector to support the economic recovery in the euro area. The results have shown that the vast majority of significant euro area banks are able to withstand a major adverse macro-financial shock without breaching the 5.5% CET1 ratio threshold. The findings of the ECB's latest bank lending survey, which indicate that banks have begun to ease their lending standards, corroborate the conclusion reached in the comprehensive assessment that the importance of supply-side constraints in euro area credit markets has diminished.

4 These results include two banks which are implementing restructuring plans agreed with the European Commission, under which one bank would have a zero shortfall and one bank would have a small shortfall.

## BANKING SECTOR OUTLOOK AND RISKS

### Outlook for the banking sector on the basis of market indicators

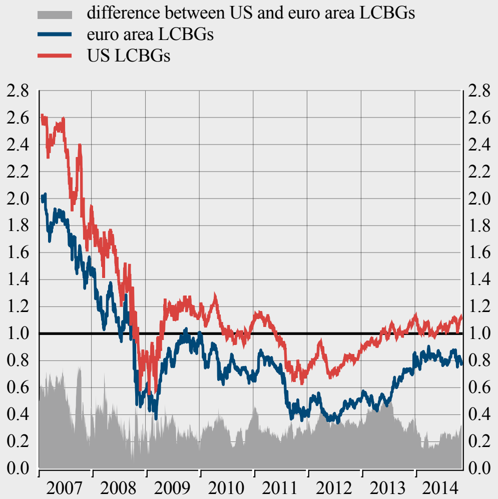
*Market-based indicators point to a stabilisation of banks' outlook*

Market-based indicators suggest an unchanged outlook for euro area banks over the last few months. In particular, the improving trend in euro area LCBGs' price-to-book ratios that started around mid-2013 appears to have come to a halt in the second quarter of 2014 (see Chart 3.14). On the one hand, this mirrors similar developments for other global banks, including US LCBGs. On the other hand, the latest reading of this ratio suggests a weaker outlook for euro area banks compared with US peers, possibly reflecting concerns about the profit-generating capacity of euro area banks in an environment of low nominal growth.

Indeed, market expectations suggest a weak earnings outlook for euro area banks, with many banks expected to achieve returns below their cost of equity. In fact, while the latest earnings forecasts for euro area banks signal an improvement for 2015, market expectations of profitability remain at rather moderate levels (see Chart 7 of the Overview). Similarly, a frequently cited market-based measure of systemic banking sector stress suggests that, following the significant decline since mid-2013, systemic risk within euro area banks has stabilised at a low level (see Chart 3.15).

**Chart 3.14 Price-to-book ratios of large and complex banking groups in the euro area and the United States**

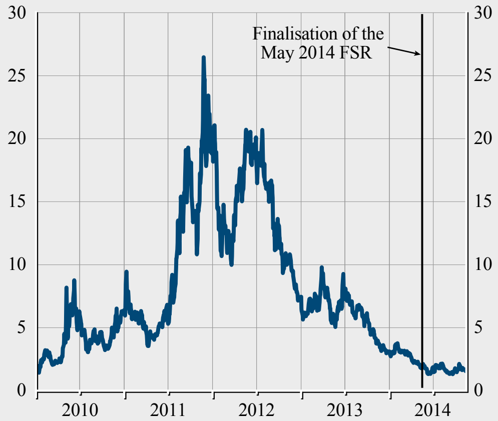
(Jan. 2007 – Nov. 2014; ratio)




Sources: Bloomberg, SNL and ECB calculations
Note: Median values for LCBGs in the United States and the euro area.

**Chart 3.15 Measure of euro area banking sector stress**

(Jan. 2010 – Nov. 2014; probability; percentages)




Sources: Bloomberg and ECB calculations.
Notes: The measure contains the credit default swap implied probability of two or more of a sample of 15 banks defaulting simultaneously over a one-year horizon. See Box 8 in *Financial Stability Review*, ECB, June 2012, for further details.

### Credit risks emanating from banks' loan books

*Credit risk remains elevated…*

The level of credit risk in the loan book of the euro area banking sector remains elevated against the background of a tenuous economic recovery and legacy balance sheet issues that still represent a challenge in several countries. Bank lending has remained weak, particularly lending to the corporate sector, while lending to households has declined only slightly (see Chart 3.16). Although the effects of this are mitigated or offset by financial disintermediation in the case of larger firms with access to international bond markets, small and medium-sized firms that are reliant on bank-based finance continue to bear the negative consequences.

This challenge for the euro area banking sector is, however, part of a broader phenomenon of non-financial sector deleveraging in many advanced economies. Indeed, credit conditions across OECD economies have remained relatively weak by historical standards, with the global credit gap for OECD countries remaining well below its early warning threshold for costly asset price booms, despite some further improvement up to the first quarter of 2014 (see Chart 3.17).

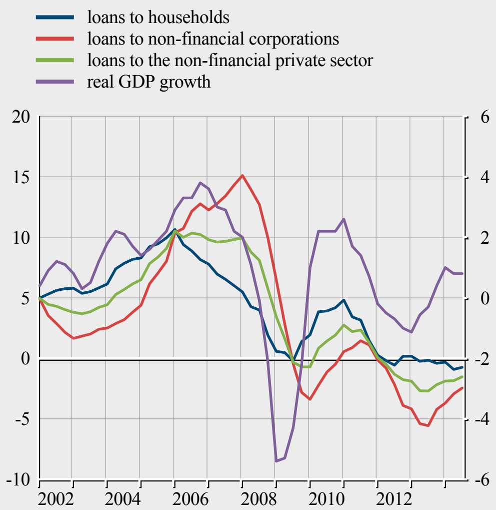
These aggregate developments, however, conceal major differences in lending conditions across regions and countries as economic recoveries proceed at different speeds. Within the euro area, credit developments differed significantly across countries (see Chart S.1.14), with continued sharp declines in lending to non-financial corporations in more vulnerable countries contrasting with flat lending volumes in core countries, thereby raising concerns regarding a credit-less recovery.

*… while credit standards show some signs of easing…*

Bank lending survey information suggests that much of the observed weakness in credit flows over the past year or so has been more closely linked to anaemic credit demand, with credit supply constraints playing a diminished role. In this vein, the results of the October 2014 euro area bank lending survey reveal some signs of easing credit standards for loans to both non-financial

**Chart 3.16 GDP growth and growth in credit to households and non-financial corporations in the euro area**

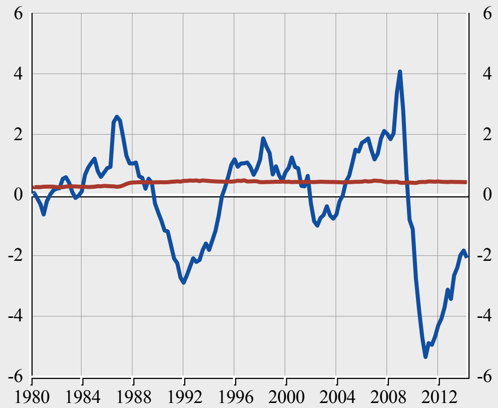
(Q1 2002 – Q2 2014; percentage change per annum)




Sources: ECB and Eurostat.
Note: The Q3 2014 GDP growth figure is based on the flash estimate by Eurostat.

**Chart 3.17 Global credit gap and optimal early warning threshold**

(Q1 1980 – Q2 2014; percentages)




Sources: ECB and ECB calculations.
Note: Index for 18 OECD countries – see Alessi, L. and Detken, C., "Quasi real time early warning indicators for costly asset price boom/bust cycles: A role for global liquidity", *European Journal of Political Economy*, Vol. 27(3), September 2011.

corporations (NFCs) and households. They also point to a recovery in credit demand not only by households, irrespective of the purpose of the loan, but also by NFCs, regardless of the firm size (see Chart 3.18).

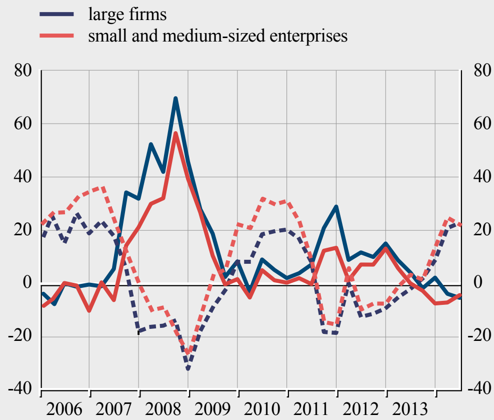
While these signs could indicate a turning point in credit flows, they are closely tied to the pace of economic expansion and its impact on income and earnings risks for households and NFCs in a context of ongoing challenging balance sheet adjustment.

Notwithstanding the importance of demand conditions, legacy asset quality problems in vulnerable countries also weigh on new lending. At the country level, a continued expansion of NPLs is particularly visible in the most vulnerable euro area countries, although there are some tentative signs of a slowdown in new NPLs in some countries, or even of a reversal of worsening asset quality trends, most notably in Spain.

While a further expansion of NPLs is likely in countries with weak macroeconomic conditions in the coming quarters, there are some tentative

**Chart 3.18 Credit standards and demand conditions in the non-financial corporation sector**

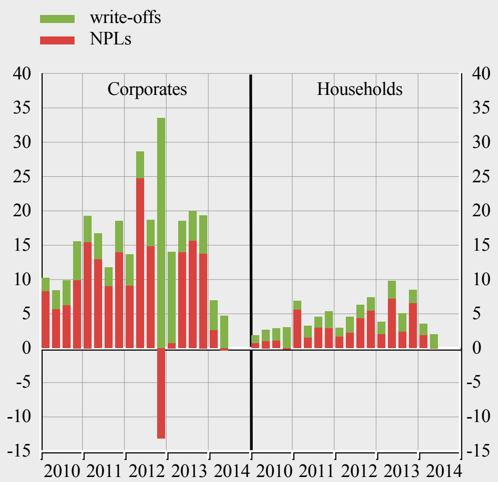
(Q1 2006 – Q4 2014; weighted net percentages)




Source: ECB.
Notes: The solid lines denote credit standards, while the dotted lines represent credit demand. Credit standards refer to the net percentage of banks contributing to a tightening of credit standards, while credit demand indicates the net percentage of banks reporting a positive contribution to demand.

**Chart 3.19 Quarterly change in non-performing loans and loan write-offs in Spain, Italy and Portugal**

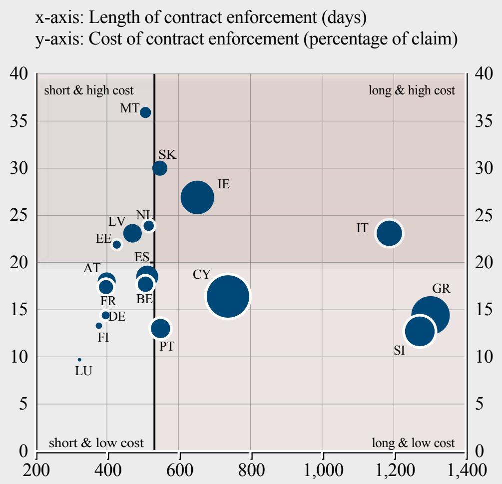
(Q1 2010 – Q2 2014; EUR billions)




Source: National central banks.

**Chart 3.20 Length and cost of contract enforcement and non-performing loan ratios across the euro area**

(2014)




Sources: World Bank Doing Business 2014 and ECB.
Note: The size of the bubble represents the NPL ratio at year-end 2013.

signs that the pace of credit quality deterioration could slow in an increasing number of countries as the economic recovery gains momentum. In fact, the combined quarterly change in corporate NPLs in three of the vulnerable countries where sectoral NPL data are available (Spain, Italy and Portugal) shows a decline in the first two quarters of 2014, although it was driven mainly by developments in Spain (see Chart 3.19). At the same time, there is little sign of a pick-up in loan write-offs, suggesting that banks in these countries still need to make further progress in resolving the issue of NPLs.

*…with further progress needed in the disposal of NPLs*

The comprehensive assessment exercise accelerated the process of bank balance sheet repair, ensuring prudent asset valuation and stricter loan loss recognition, as well as providing more transparency on asset quality. Complementing this, the cleaning-up of bank balance sheets should be fostered at the national level by removing legal and judicial obstacles to timely NPL resolution (see Chart 3.20).

Finally, for some euro area banks, credit risks also emanate from their significant cross-border exposures. Indeed, some SBGs remain highly exposed to emerging market economies (EMEs), based on the ratios of their exposure at default (EAD) to common equity, in particular to countries in "developing Europe".[2] A few banks with exposures to the most vulnerable EMEs (including Russia and Ukraine) have incurred higher credit losses in the first half of 2014, and face the risk of asset quality deterioration in the event of geopolitical tensions persisting for longer and/or the macroeconomic environment in some EMEs deteriorating further. The SBGs exposed most to those EMEs could face higher loan losses on these portfolios in the period ahead.

### Funding liquidity risk

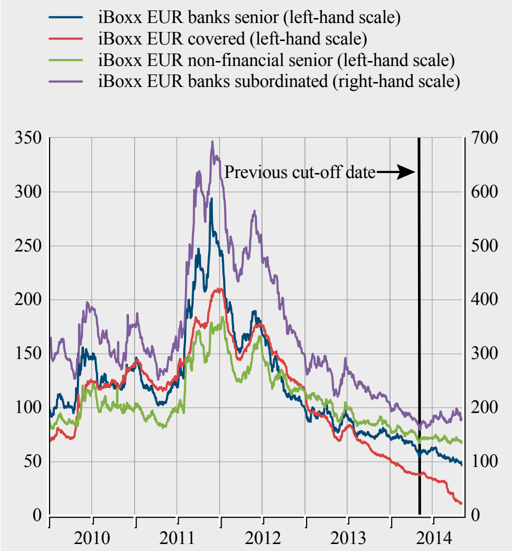
*Funding conditions remained very favourable…*

**Market-based bank funding conditions** remained very favourable, with average spreads on bank debt stabilising below the levels seen in early 2010, i.e. before the start of the sovereign debt crisis. Spreads on different debt instruments have diverged somewhat since mid-2014, with a further

2 See *Financial Stability Review*, ECB, May 2014.

**Chart 3.21 Spreads on banks' senior debt, subordinated debt and covered bonds**

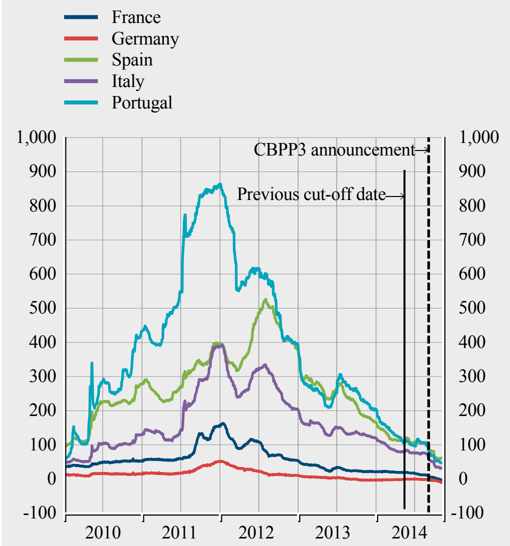
(Jan. 2010 – Nov. 2014; basis points)




Sources: ECB and Markit.

**Chart 3.22 Covered bond spreads in vulnerable and other euro area countries**

(Jan. 2010 – Nov. 2014; basis points)



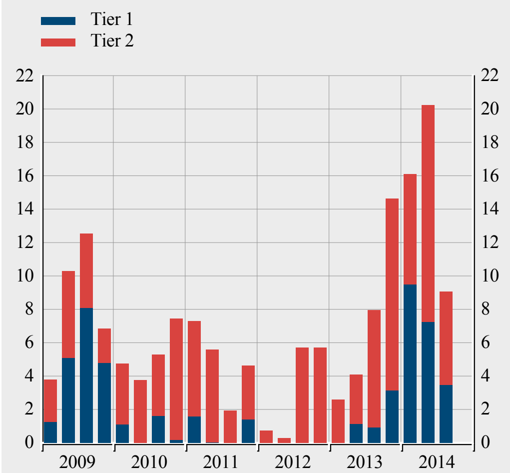

Sources: ECB and Markit.

tightening of those on covered bonds and, to a lesser extent, senior unsecured debt contrasting with some widening of spreads on subordinated debt (see Chart 3.21). Fragmentation in the pricing of bank debt declined further, as reflected, for instance, in the narrowing differential between spreads on covered bonds issued by banks in vulnerable and other countries, which recently also benefited from the ECB's announcement of a third covered bond purchase programme (CBPP3) (see Chart 3.22). Market-based funding remained widely available, although debt issuance by euro area banks in recent months was below last year's levels, including for banks in vulnerable countries, on the back of increased volatility in credit markets.

**Debt issuance** patterns reflected banks' efforts to adapt their debt and capital structures to new regulatory requirements, as well as continued strong investor demand for higher-yielding bank debt. As a result, subordinated debt issuance has seen the most significant increase in the year to date, including both additional Tier 1 and Tier 2 instruments (see Chart 3.23), as banks continued to build up their subordinated debt buffers in preparation of meeting the CRR/CRD IV total capital/Tier 1 capital ratio, as well as minimum bail-in requirements. Despite a recent slowdown, issuance of junior

**Chart 3.23 Issuance of subordinated debt by euro area banks**

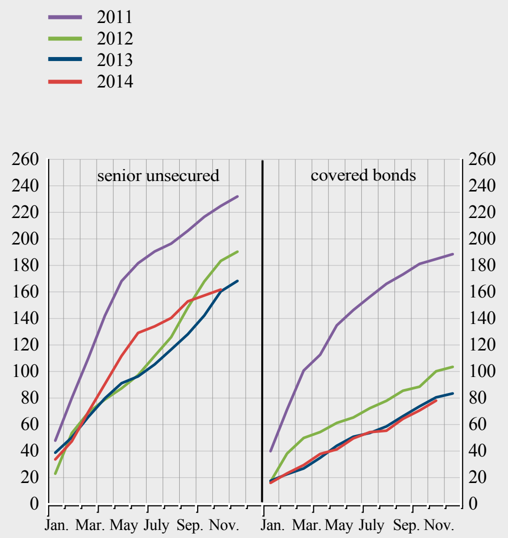
(Q1 2009 – Q3 2014; EUR billions)




Source: Dealogic.
Note: Excludes retained deals and government-guaranteed issuance.

**Chart 3.24 Cumulative yearly issuance of senior unsecured debt and covered bonds by euro area banks**

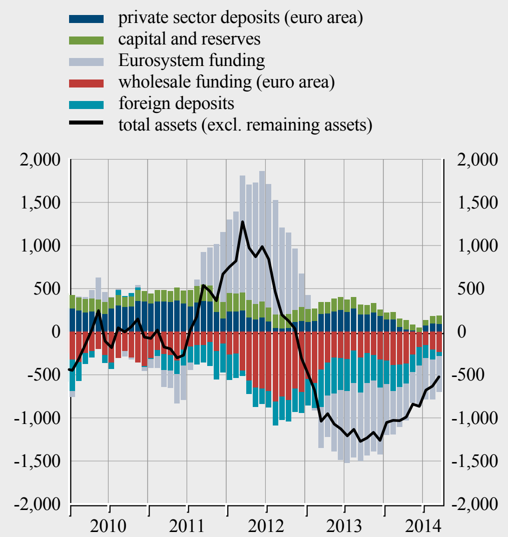
(Jan. 2011 – Nov. 2014; EUR billions)




Source: Dealogic.
Notes: Excludes retained deals and government-guaranteed issuance. November 2014 includes data up to the middle of the month.

**Chart 3.25 Twelve-month flows in the main liabilities of the euro area banking sector**

(Jan. 2010 – Sep. 2014; 12-month flows; EUR billions)




Source: ECB.
Notes: Total assets are adjusted for remaining assets, which consist largely of derivatives. Wholesale funding comprises interbank liabilities and debt securities.

debt by euro area banks in the first nine months of 2014 more than tripled in comparison with a year earlier. Issuance activity in the senior unsecured debt market has slowed since mid-2014, partly also reflecting reduced funding needs following robust issuance in the first half of 2014 (see Chart 3.24). Meanwhile, covered bond issuance up to October remained slightly below last year's level, although it started to show some signs of a pick-up in November, also thanks to the implementation of the ECB's CBPP3.

At the same time, issuance of asset-backed securities (ABSs) by euro area banks remains moderate. In fact, in 2014 thus far, euro area banks have placed less than €30 billion of ABSs with investors, around 30% less than a year earlier. Going forward, however, the ABS market and euro area banks' off-balance-sheet financing are likely to benefit from the ECB's ABS purchase programme.

*… and the shift towards deposit funding continued*

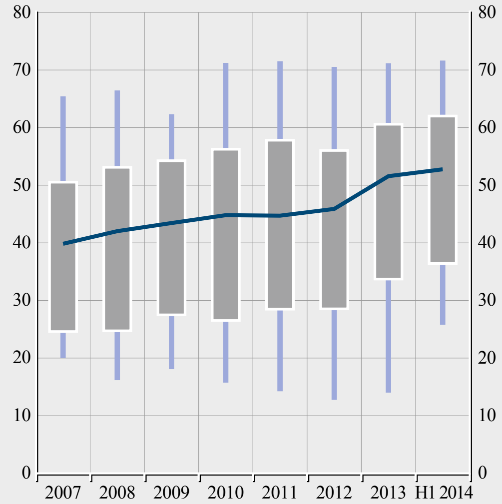
Turning to structural changes in bank funding, deposit flows slowed in the first nine months of 2014, with further negative net flows of wholesale funding – consistent with continued deleveraging – while the share of customer deposits increased further (see Chart 3.25). As a result, the median ratio of customer deposits to total liabilities for SBGs reached 53% in mid-2014, up from 46% at the end of 2012 (see Chart 3.26). Providing yet another sign of declining euro area fragmentation, banks in both vulnerable and other countries benefited from a shift towards deposit funding (as a share of total funding), even if this was due more to shrinking reliance on other funding sources such as wholesale and Eurosystem funding than to deposit growth.

Similarly, banks' loan-to-deposit ratios (a proxy of their reliance on wholesale funding) continued to decline gradually in the first half of 2014, with the median ratio for SBGs reaching 115% at the end of June, representing a significant fall from its pre-crisis peak of 143% in 2007. Nevertheless, the dispersion of loan-to-deposit ratios remains wide, and some institutions continue to be dependent on wholesale funding. These banks need to make further adjustments in their funding profiles, with some business models (e.g. those of some German Landesbanken) facing particular challenges in this regard.

Looking at funding challenges beyond the short term, banks' changing debt/capital structures – characterised by the rising share of loss-absorbing and bail-inable instruments – should contribute to a safer system and more efficient resolution mechanisms. However, these changes also create challenges of their own. The fast-growing market for contingent convertible capital instruments (CoCos) remains untested, with no investor loss event (trigger or coupon deferral) having occurred thus far, creating some uncertainty as to whether such an event would be seen as idiosyncratic or could affect the asset class more profoundly. This highlights the need for investors to gain a better understanding of how different features of CoCos impact on the risk profile of these investments (see Box 5).

**Chart 3.26 Share of customer deposits in total liabilities for euro area banks**

(2007 – H1 2014; percentage of total liabilities; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.
Note: Based on publicly available data on SBGs that report annual financial statements and on data on a sub-set of those banks that report on a semi-annual basis.

Regarding potential implications of bail-ins, the subordinated debt market remained resilient to recent bail-ins (Banco Espirito Santo and Hypo Alpe Adria), although this may also reflect the relatively small size of the bailed-in debt involved. Looking ahead, however, as some countries are planning to bring forward senior debt bail-in rules as of 2015, rating agencies have indicated that they would review ratings on the basis of how the bail-in legislation is expected to affect government support. This could cause rating agencies to reduce or eliminate systemic support in the ratings, which would put pressure on senior debt ratings, in particular for those banks that currently enjoy a multi-notch uplift through implied government support.

**Box 5**

## DO CONTINGENT CONVERTIBLE CAPITAL INSTRUMENTS AFFECT THE RISK PERCEPTIONS OF SENIOR DEBT HOLDERS?

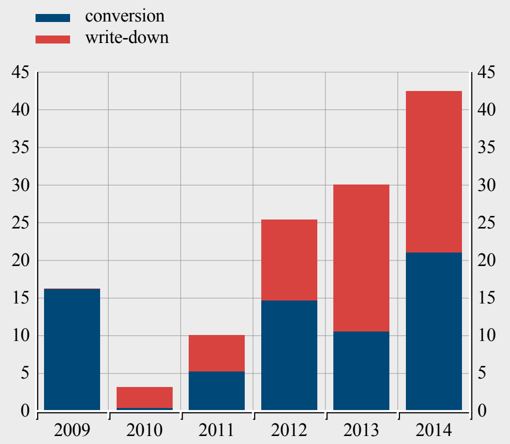
Contingent convertible capital instruments or bonds (CoCos) are hybrid instruments that are automatically transformed into equity or are written off in the event of a capital shortfall. CoCos thus contain built-in mechanisms for absorbing losses when trigger points are reached. CoCos are flexible instruments that are able to boost regulatory CET1 capital ratios when necessary, while preserving the respective debt status if the pre-specified trigger level is not reached. They have grown in popularity in recent years, not least on account of their state-contingent nature, their distinct accounting treatment and the fact that they combine elements of debt and equity.

The attractive features of CoCo instruments for issuers and investors have led to marked growth in this market. But as the importance of this nascent market for the structure of banks' liabilities increases, the risks involved may rise as well. The market has experienced dramatic growth over the last few years, with an increasing share of write-down instruments.[1] The supply of such hybrids appears closely related to a need of banks to increase their capital ratios in line with the new Basel III standards. On the demand side, the higher coupons paid to investors in CoCos in comparison with those of many other financial assets have proven to be very attractive in the current low-yield environment (see Chart A). The market is quite important in Europe, which has seen greater use of CoCos than the rest of the world (see Chart B).

One factor obfuscating an aggregate view of risk related to the growing market for these instruments is that contingent convertible bonds are complex in structure and, as a result, no two such hybrid instruments are identical. That said, the underlying loss-absorption mechanism is a key channel through which risk may arise, as this conduit for risk-taking incentives for holders of equity can create externalities.[2] The theoretical literature on hybrid debt is closely related to whether such instruments contain "write-down" or "conversion" clauses. Since write-down instruments imply that losses at the trigger point are first borne by CoCo investors, this could increase the risk-taking incentives for bank owners. By contrast, instruments with a conversion-to-equity clause imply that, if triggered, current equity holders suffer from the dilution of their shares. This aligns the interests of CoCo investors and shareholders, incentivising the latter to limit risk-taking in order to avoid triggering the CoCos. Hilscher and Raviv analyse the stabilising effect of CoCos on the issuing bank, conditional on the features of the instrument, concluding that a high conversion ratio significantly reduces the risk-taking incentives of stock-holders.[3] Berg and Kaserer show that a significant reliance on CoCos can lead to more

**Chart A Contingent convertible bond issuance: write-down versus conversion**

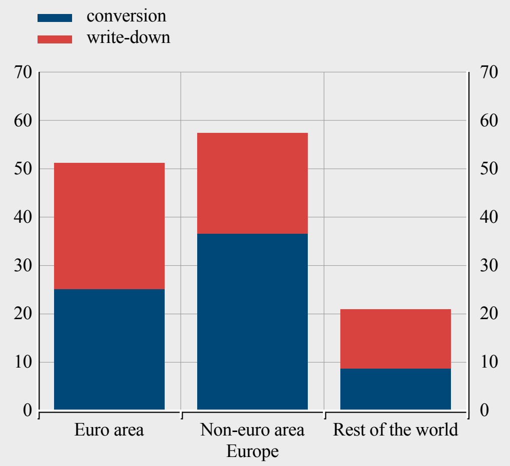
(July 2009 – Aug. 2014; EUR billions)




Sources: Dealogic, Bloomberg and ECB calculations.

**Chart B Cumulated amounts of contingent convertible bonds issued, broken down by region**

(Aug. 2014; EUR billions)




Sources: Dealogic, Bloomberg and ECB calculations.

1 See also Box 9 in *Financial Stability Review*, ECB, May 2014.
2 It should be noted that shareholders may be reluctant to allow capital levels to reach the trigger point as that could lead to restrictions on dividend payments.
3 See Hilscher, J. and Raviv, A., "Bank stability and market discipline: The effect of contingent capital on risk taking and default probability", *Journal of Corporate Finance*, 2014.

risk-taking, especially when capital ratios approach the trigger level.[4] Such behaviour could be amplified further by write-down clauses, as they imply only losses for holders when the trigger is reached. A significant level of dilution can hence help align the incentives of shareholders and those of the bondholders and reduce endogenous risk. These considerations raise the question as to whether different CoCo features create incentives for risk-taking by issuing banks.

An analysis of the effect of CoCo issuance on the pricing of senior unsecured debt (five-year credit default swap (CDS) spreads) suggests that the risk perception of senior bond holders depends crucially on the risk-taking incentives that CoCos may create for equity holders. The sample covers quarterly panel data for the period from the third quarter of 2009 to the first quarter of 2014 and for 60 banks (20 CoCo issuers and 40 non-issuers) from 19 countries.[5] First, the analysis aims at disentangling the effect of conversion/write-down CoCo dummies on CDS spreads. In a second step, the explanatory power of the quantity of CoCos as a percentage of equity is analysed. Since the control group is represented by non-issuers, the coefficients in the second column of the table below represent the effect of adding one more percentage point of CoCos relative to equity.

The point estimates in the first column of the table below show that the effect of the write-down dummy is positive and significant. Hence, a bank with write-down CoCos is perceived by senior bond holders to be riskier when compared with non-issuers, and this is reflected in a significantly larger increase in CDS spreads. Moving to the second column of the table of results, the effect of write-down instruments as a proportion of total equity is also positive. This implies that higher costs for protection against default are associated with a stronger reliance on write-down instruments in the capital structure. These results are quite illustrative, as empirical work on CoCo instruments and their impact on risk perceptions and incentives has remained limited, despite the recent surge in theoretical research.

Such results are consistent with the notion that issuing CoCos with a write-down clause appears to increase the perceived risk of a bank. On the other hand, the results suggest that holding instruments that are converted to equity if triggered has a negative impact on the change in bank CDS spreads, although that impact is insignificant in terms of quantities. As the prevalence of these instruments increases, a better understanding of their characteristics and behavioural implications in stressed market conditions is crucial for understanding their prospective impact on financial stability.

**Impact of contingent convertible bonds on the change in banks' CDS spreads**

| Variables | ΔCDS | ΔCDS |
|---|---|---|
| Conversion dummy | -31.62* | |
| Write-down dummy | 28.21*** | |
| Conversion quantity in total equity | | -2.97 |
| Write-down quantity in total equity | | 2.83** |
| R2 | 0.471 | 0.470 |

Notes: The analysis is performed using a panel fixed effects estimator, with bank individual effects, quarter dummies and bank-clustered standard errors. The regressions are augmented with bank balance sheet variables (bank balance sheet and regulatory indicators, size) and country risk (sovereign CDS spread), but their effect is not shown.
***, **, * indicates significance at the 1, 5 and 10% levels.

4 See Berg, T. and Kaserer, C., forthcoming.
5 For further details on the empirical analysis, see Bicu, A., Stolz, S. and Wedow, M., "Layer cake: Risk incentive effects of CoCos".

### Market-related risks

*Interest rate risk remains material…*

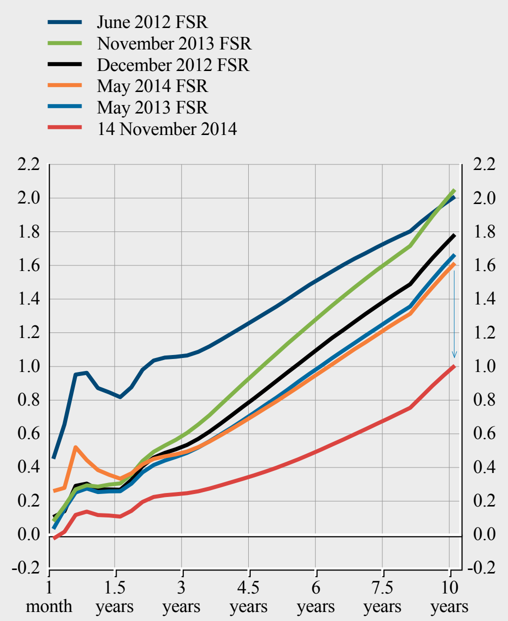
Banks' interest rate risk has remained material against the background of both still high sovereign exposures in some parts of the euro area and the continued flattening of the euro area yield curve, which has adverse implications for the profits banks garner from maturity transformation activities (see above). Since the finalisation of the May 2014 FSR, there has been a further substantial decline in sovereign yields, particularly at the long end of the yield curve (see Chart 3.27), with continued yield compression also extending to bonds of lower-rated sovereigns. Against this backdrop, euro area banks remain vulnerable to a potential reassessment of risk premia in global markets, in particular through their direct exposures to higher-yielding debt instruments, via possible valuation losses on their sovereign bond exposures, depending on the duration of these portfolios and on the extent to which their positions are hedged.

*... with some banks still exposed to lower-rated sovereign debt…*

In this regard, data on the holdings of government debt by monetary financial institutions (MFIs) in the euro area show a continuation of home bias in sovereign debt holdings for banks in most euro area countries (see Chart 3.28). Despite recent declines, sovereign bond holdings as a percentage of total assets remain well above pre-crisis levels in some countries. Furthermore, some banks attempted to offset declining yields by extending the duration of their bond portfolios. As confirmed by bank-level data from the comprehensive assessment exercise, mid-sized SBGs have higher exposures, on average, to lower-rated sovereigns in their respective countries, leaving them more vulnerable than larger banks to adverse yield movements.

**Chart 3.27 Developments in the euro area yield curve**

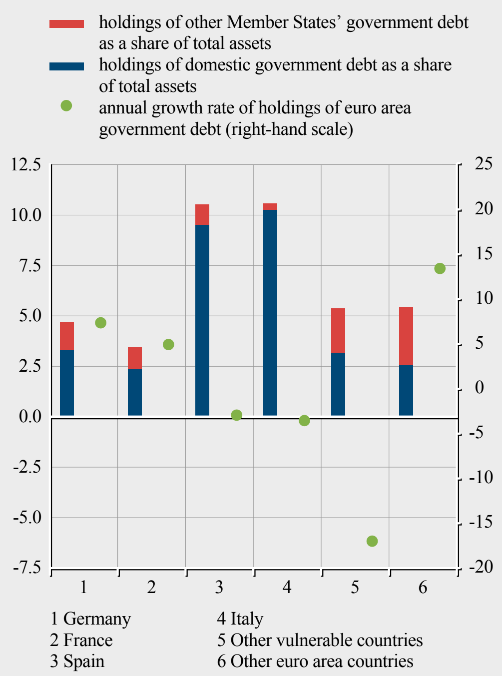
(percentages)




Sources: ECB and Thomson Reuters.

**Chart 3.28 MFIs' holdings of sovereign debt, broken down by country**

(Sep. 2013 – Sep. 2014; percentage of total assets; annual growth rate)



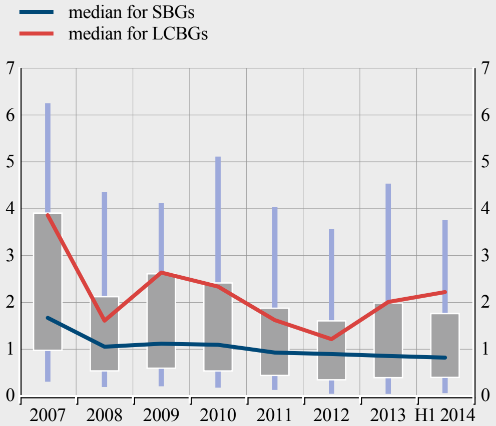

Source: ECB.
Note: "Other vulnerable countries" refer to Cyprus, Greece, Ireland, Portugal and Slovenia.

*… while corporate bond exposures remain limited*

With respect to other fixed-income exposures, euro area MFIs' holdings of euro area non-financial corporate debt were stable in the first two quarters of 2014, with the share of these securities in banks' balance sheets remaining limited at around 0.5%. This suggests that the direct impact of a sharp adjustment of risk premia on euro area corporate bonds would be contained at the aggregate level. However, some banks with material exposures to high-yield or EME corporate bonds could be more negatively affected in such a scenario.

**Chart 3.29 Euro area banks' holdings of equity instruments**

(2007 – H1 2014; percentage of total assets; 10th and 90th percentiles and interquartile range distribution across SBGs)




Source: SNL Financial.

Finally, euro area banks' exposure to equity markets remained, on average, broadly unchanged in the first half of 2014, but with significant heterogeneity across banks of different sizes (see Chart 3.29). In particular, LCBGs have increased their exposure to this asset class since end-2012. This could be related in part to the fact that low equity market volatility tends to compress backward-looking risk measures, such as the value at risk (VaR), thereby inducing some banks to increase their exposure.

## 3.2 THE EURO AREA INSURANCE SECTOR: RESILIENCE AMID CONTINUED HEADWINDS

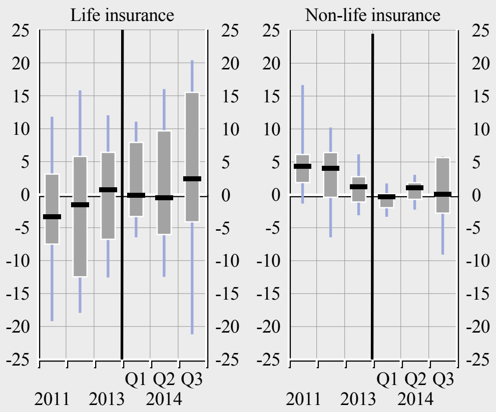
### FINANCIAL CONDITION OF LARGE INSURERS[3]

*Insurers resilient so far…*

The performance of large euro area insurers remained stable, despite headwinds from a low interest rate environment and only moderate economic growth. Overall, the sector exhibited modest growth in premiums written during the second and third quarters of 2014 (see Chart S.3.22 in the Statistical Annex), although median growth was relatively muted in the life insurance sub-sector during the first half of the year (see Chart 3.30). Life insurers appear to be particularly affected by the low interest rate environment – especially those offering guaranteed products. Nevertheless, this segment appears to be weathering the headwinds, given continued significant cost savings and an optimised product mix. Overall, combined ratios (i.e. incurred losses and expenses as a proportion of premiums earned) were somewhat

**Chart 3.30 Gross-premium-written growth for a sample of large euro area insurers**

(2011 – Q3 2014; percentages; 10th and 90th percentiles, interquartile distribution and median)




Sources: Bloomberg, individual institutions' financial reports and ECB calculations.

3 The analysis is based on a varying sample of 21 listed insurers and reinsurers with total combined assets of about €4.9 trillion in 2013, which represent around 80% of the assets in the euro area insurance sector. Quarterly data were only available for a sub-sample of these insurers.

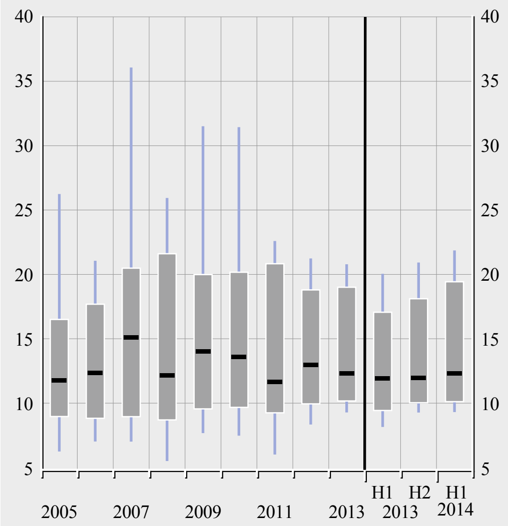
higher in the second quarter of 2014, impacted by higher loss ratios (see Chart S.3.23). Still solid investment income and the absence of any major global natural catastrophe have both been crucial factors underpinning the stable profitability of large euro area insurers (see Chart S.3.21). Moreover, the heterogeneity of investment income performance, which previously had exhibited a strong cross-country dimension, seems to have subsided considerably, mainly on account of a convergence of the yields on benchmark euro area government bonds.

*… despite low yields in all euro area jurisdictions*

The capital base of large euro area insurers remained stable at comfortable levels (see Chart 3.31), supported by falling yields on government bonds, which form the bulk of insurers' assets. While this signals an average underlying resilience of these large insurers, regulatory factors may be playing a role as well, since fair value accounting of assets, but not of liabilities, as is applied in most jurisdictions, implies accounting benefits from the decline in most sovereign yields.[4]

**Chart 3.31 Capital positions of large euro area insurers**

(2005 – H1 2014; percentage of total assets; 10th and 90th percentiles, interquartile distribution and median)




Sources: Bloomberg, individual institutions' financial reports and ECB calculations.
Note: Capital is the sum of borrowings, preferred equity, minority interests, policyholders' equity and total common equity.

### INSURANCE SECTOR OUTLOOK: MARKET INDICATORS AND ANALYSTS' VIEWS

*Market indicators show some volatility*

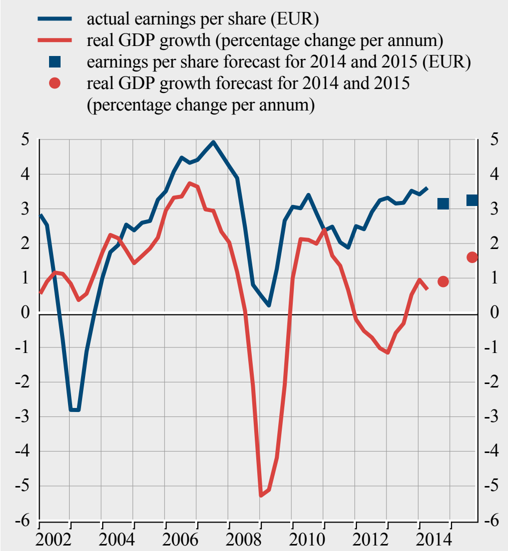
Market-based indicators suggest a relatively stable outlook for the euro area insurance sector next year. The share prices of the most important euro area insurance companies showed some volatility in the summer and, most notably, in September when, following a change in management at PIMCO, turbulence relating to the share price of Allianz created some volatility in fixed-income markets, in which insurers are very active players (see Chart S.3.30). In addition, the downward trend in credit default swap (CDS) spreads across large insurers stabilised somewhat at relatively low levels in the last months (see Chart S.3.28).

*Analysts expect stable earnings*

Analysts also expect euro area insurance earnings to remain relatively stable in 2014 and 2015, although subdued economic growth may pose additional challenges to profitability (see Chart 3.32). Given historically

**Chart 3.32 Earnings per share of selected large euro area insurers and real GDP growth**

(Q1 2002 – 2015)




Sources: ECB, Thomson Reuters and ECB calculations.

4 Upon the implementation of Solvency II in 2016, valuation of assets and liabilities will shift to a market-based approach.

low interest rates in all jurisdictions, there is considerable pressure on insurance companies to seek higher returns on their investments. At the same time, analysts generally expect most euro area insurers to be able to meet their guarantees for a prolonged period, even in the case of low investment returns, as other sources of income from new business should be supported by product innovations and a temporary revival of demand for traditional life insurance products in core markets. In addition, cost-cutting appears to be a common trend throughout the industry.

Analysts have also noted an increase, at an industry level, in risk appetite in terms of longer duration and increasing demand for corporate debt within fixed-income portfolios. Thus far, this appears to be still relatively contained for large euro area insurers, as aggregate volumes of high-yield bonds and other more risky investments remain stable. High levels of capitalisation, in particular in the reinsurance sector, have increased expectations of higher dividends.

*Sector faces multiple challenges*

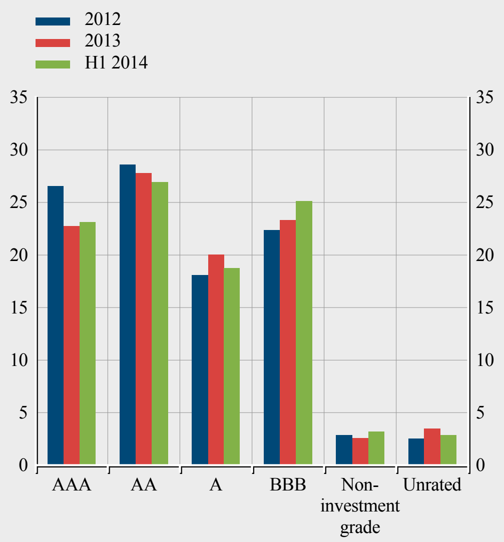
Despite the generally stable outlook for the euro area insurance sector, challenges persist in the months ahead. In the reinsurance sub-sector, an abundant supply and stagnant demand are expected to fuel further declines in prices in 2015, making it challenging for reinsurers to earn their cost of capital. In addition, analysts expect the low-yield environment to have a negative impact on investment income, hampering profitability throughout the insurance sector in the euro area and testing the long-run viability of some life insurers' business models. Finally, individual insurers in some euro area jurisdictions may be confronted with higher than expected litigation costs.

## INVESTMENT RISK

Investment activity remains highly concentrated on traditional fixed-income segments, such as government and corporate bond markets (see Chart S.3.25). However, given the crucial role that investment income plays in insurers' business models and the expected persistence of currently low yields in fixed-income markets, insurance companies have been seeking higher returns in alternative investments. Some signs of portfolio adjustments were visible in some large euro area insurers, with investment in equities increasing since 2013 and investment in structured credit and commercial property declining slightly over the same period. In addition, although fixed-income portfolios are clearly dominated by highly rated bonds, there was a very slight increase in the proportion of higher-yield bonds (see Chart 3.33).

**Chart 3.33 Bond investments of selected large euro area insurers split by rating categories**

(percentage of total bond investments; weighted averages)




Sources: Company reports, JPMorgan Cazenove and ECB calculations.
Note: Based on the available data for 12 large euro area insurers.

*Emerging market debt increasing*

In terms of geographical orientation, long-term investors have further increased their exposure towards emerging economies' bond markets. Emerging market debt accounts for an increasing share of the return-seeking portfolios of both life and non-life insurers. Although the proportion of emerging market bonds in the fixed-income portfolios of most euro area large insurers is currently relatively low, sizeable future increases would create concerns about currency risk on their books. On the one hand, with Solvency II, 25% of capital will be required to be held against assets held in any currency other than that used to prepare the insurer's financial statements. On the other hand, hedging currency risk – for instance, by means of a deliverable forward contract – is also expensive, which might act as a pecuniary deterrent for insurance companies.

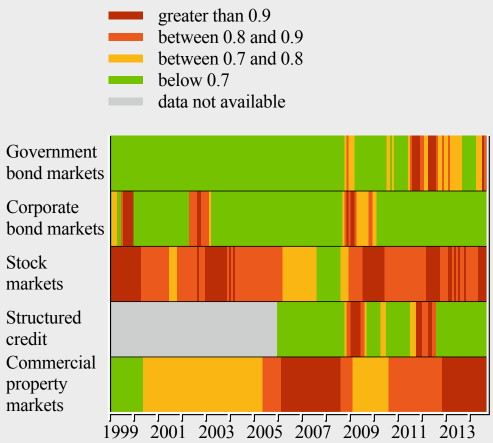
*Widespread low yields are a real threat…*

An investment uncertainty map signals stress in several markets (see Chart 3.34). With government bond yields reaching historical lows in almost all jurisdictions during the summer and investors expecting rates to remain low, challenges to economic solvency and investment income persist. If sustained, this environment – together with weak economic growth – could potentially impact profitability further, eroding capital positions, in particular of small and medium-sized life insurers in jurisdictions where fixed guarantees are offered to policyholders. Naturally, given the weight of fixed-income securities in insurers' assets, a major concern remains the potential for a sudden rise of risk-free rates.[5] On the one hand, in the medium and long term, the impact of a rise is deemed to be mainly positive in terms of higher investment income, economic solvency and embedded value. Life insurers would benefit most, given the longer duration of their liabilities relative to assets. On the other hand, in the short term, the impact thereof on stated equity and price-to-book ratios may also be a concern, leading to an abrupt temporary increase in market volatility with a potential short-term risk to share prices. This could affect insurers with short-duration assets, particularly

*… although the industry is prepared for sudden-rise scenarios*

**Chart 3.34 Investment uncertainty map for the euro area**

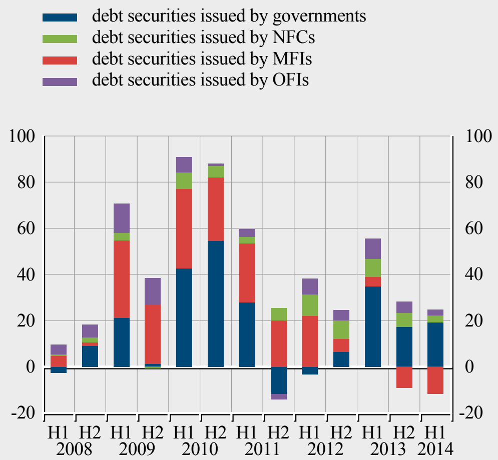
(Jan. 1999 – Oct. 2014)




Sources: ECB, Bloomberg, JPMorgan Chase & Co., Moody's, Jones Lang LaSalle and ECB calculations.
Notes: Each indicator is compared with its "worst" level since January 1999. "Government bond markets" represent the euro area ten-year government bond yield and the option-implied volatility of German ten-year government bond yields, "Corporate bond markets" A-rated corporate bond spreads and speculative-grade corporate default rates, "Stock markets" the level and the price/earnings ratio of the Dow Jones EURO STOXX 50 index, "Structured credit" the spreads of residential and commercial mortgage-backed securities, and "Commercial property markets" commercial property values and value-to-rent ratios.

**Chart 3.35 Portfolio transactions of euro area insurance companies**

(H1 2008 – H1 2014; EUR billions)




Source: ECB.
Notes: Data availability varies across countries and investment categories. "MFIs" refer to monetary financial institutions, "NFCs" to non-financial corporations and "OFIs" to other financial intermediaries. Counterparties reside in the euro area.

5 The impact of rising or falling interest rates is only relevant if there is a duration mismatch between assets and liabilities. If an insurer is short duration (i.e. lower asset duration than the liability duration), a rising interest rate is beneficial as the fall in asset value is lower than the fall in liability value, i.e. the capital position improves. This is normally the case for the majority of the life insurers. Very rarely, insurers are long duration (i.e. asset duration higher than the liability duration) although technically non-life insurers could be so.

if they offer attractive dividends. In addition, non-life insurers might be tempted to use higher investment incomes to cut prices and reduce underwriting margins. At a global level, the desire to remain flexible in the face of possibly rising interest rates is inducing more insurance companies to consider absolute-return investment approaches, ahead of other approaches, such as book yield, relative return and liability matching.[6]

*Slow portfolio adjustment…*

Euro area insurers have increased their holdings of government bonds in almost all jurisdictions (see Chart 3.35) – in some cases with a high domestic sovereign focus – according to transactional data, which exclude valuation changes. Holdings of debt issued by euro area corporates appears to also be on the rise. At the same time, insurers in the euro area have decreased their holdings of debt issued by euro area monetary financial institutions, although some analysts expect this trend to reverse in the near future.

*… with limited non-traditional activities thus far…*

While the insurance sector is increasing its non-traditional activities in an endeavour to boost income, their use remains limited thus far, on aggregate. Although evidence of such activities (mainly sales of credit risk protection and direct lending to counterparties) exists, levels at an aggregate euro area level remain low, and even declined slightly within the euro area in the first half of 2014.

*… despite the increase in captive activities by insurance companies*

The use of captives[7] by insurance companies raises concerns about capital arbitrage and financial soundness. The sharp increase in captive insurance entities (in particular, in the United States) and their weak disclosure obligations have recently gained the attention of the international financial stability community. Most concerns come from the use of captive life reinsurers for life insurance reserve financing and the use of inter-company loans, activities sometimes called "shadow insurance". Although currently only limited signs of such activities exist in the euro area, an expected increase in formations of captives in Europe (which currently accounts for an estimated 28% of all captives worldwide) warrants close monitoring.

### UNDERWRITING RISK

*Increased exposure to emerging markets*

Expectations of depressed top-line growth in life insurance markets in the future and a continued softening of reinsurance pricing pose challenges to the reinsurance and life insurance business models. Both life and non-life companies have further increased their amounts of premiums written in emerging markets. Such expansion brings diversification benefits in markets that are highly profitable and relatively underpenetrated at the moment. However, new challenges emerge in terms of risk management, currency risk, new product developments and group supervision.

*Manageable insured catastrophe losses…*

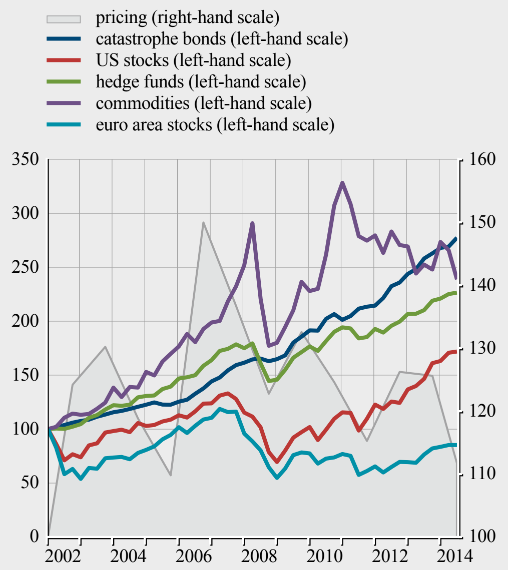
The reinsurance industry recorded manageable and below-average natural catastrophe losses in 2014 (see Chart 3.36). However, Europe was the only region to have above-average insured losses in the first half of the year. Severe thunderstorms and hail in early June caused significant damage in France, Germany and the Netherlands, with total insured losses estimated at USD 2.5 billion. In addition, aviation disasters in 2014 thus far could cost the insurance industry as much as USD 1.5 billion.

6 A relative-return approach rates the performance of the fixed-income portfolio relative to that of a public benchmark. An absolute or total-return approach considers performance relative to zero-risk assets. Relative return gives asset managers a yield target above the market average, but this may not be enough to provide the cash-flow matching and yield that insurers are seeking.

7 "Captives" are insurance companies established with the objective of financing specific risks borne by their respective owner, affiliated businesses or a designated set of companies. In the case of non-financial companies, use of captives is motivated by sound risk management and a cost-efficient pooling of risks. However, the use of captives by insurance companies might be driven by the ability to effectively move assets (and their associated liabilities) off the balance sheet in order to reduce regulatory capital requirements.

**Chart 3.36 Cumulative return profiles, broken down by market asset class and reinsurance pricing**

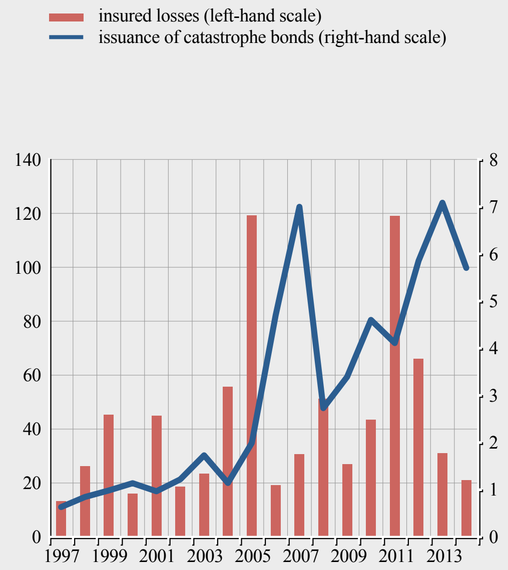
(Q1 2002 – Q3 2014; index: Q1 2002 =100)




Sources: Bloomberg, Guy Carpenter and ECB calculations.
Notes: S&P 500 and EURO STOXX are used as benchmark indices for US and euro area stocks respectively. The Guy Carpenter World Property Catastrophe RoL Index tracks changes in property catastrophe reinsurance premium rates on a worldwide basis.

**Chart 3.37 Insured catastrophe losses and catastrophe bond issuance**

(1997 – H1 2014; USD billions)




Sources: EQECAT, Munich Re, Swiss Re, Guy Carpenter and ECB calculations.
Note: Data for 2014 refer to the first six months of the year.

*… combined with an excess of capital and supply…*

Over the past two years, the reinsurance industry has seen an inflow of approximately USD 20 billion of new capital from an ever-broadening investor base,[8] precipitating the most marked change to the sector's capital structure in recent times. Capital has entered the market through investment in insurance-linked securities (mainly catastrophe bonds), funds and "sidecars", as well as through the formation of hedge fund-related reinsurance companies and collateralised reinsurance vehicles.

*… driven by the good non-correlative performance of insurance-linked securities…*

These investors have been drawn to (re)insurance on account of the advantages the sector offers in terms of being a non-correlating asset class, as well as the absence of attractive investments given the current level of interest rates. Indeed, the performance of catastrophe bonds relative to other traditional asset classes through different financial market cycles demonstrates the value of this asset class and its non-correlative basis (see Chart 3.36). Consequently, the first half of 2014 saw the highest issuance of catastrophe bonds in any six-month period, with a record high of USD 5.7 billion. These trends are expected to continue for the full year 2014 (see Chart 3.37).

*… with stagnant demand in a soft market…*

This excess of capital and capacity, combined with benign developments in natural catastrophe insured losses since 2013, has been reflected in a significant decline in prices of reinsurance policies (see Chart 3.36). In addition, new premiums written are continuing to decline as ceding companies use less reinsurance (increasing retention ratios via consolidation) as a means of stabilising profitability levels. Given these developments – weakening fundamentals and a challenging market environment – the European reinsurance sector was given a negative outlook by all rating agencies in the course of 2014. In an attempt to change the dynamics of the market, some European reinsurers have been

8 Including hedge funds, pension funds, endowments, sovereign wealth funds and asset managers.

*… create a challenging outlook for the reinsurance sector*

releasing their excess capital, via share buy-backs, higher than expected dividend payments or capital injections into direct insurance business lines, placing increased pressure on primary insurance pricing. Further cost-cutting and some consolidation are expected in the sector. As positive trends, selected lines (aviation) and countries (Germany) may enjoy slight pricing gains due to recent loss developments. Product innovation, such as protection against cyber risks, has also been pursued by some reinsurers. However, cyber risk has been poorly defined in reinsurance coverage thus far, and the market is at an incipient stage, with rather customised policies dominated by a few large providers.

*Life business model tested by low yields*

The investment guarantees that life insurers can offer new customers are driven by the yields on the bonds they can invest in. Low yields reduce the level (or increase the price) of guarantees that insurers can offer, making guaranteed savings products unattractive to customers, hampering volumes of new premiums written and potentially making the business unviable for small, not well-diversified institutions that were unable or unwilling to mitigate the risk in advance through a close matching of cash flows or hedging activities.

## 3.3 MACRO-PRUDENTIAL POLICY MEASURES ANNOUNCED IN SEVERAL COUNTRIES

This section considers the macro-prudential measures that have been implemented, or proposed, in a number of euro area countries since November 2013. It draws on a quarterly update provided by Member States. The measures introduced by the countries concerned can be grouped into two categories, depending on the risks being addressed: real estate measures and systemic risk measures. They are summarised in Table 3.1.

### SYSTEMIC RISK MEASURES

*Systemic risk measures were introduced in a number of countries…*

A number of member countries recently introduced measures to mitigate systemic risks originating from the significant size, high concentration and interconnectedness of their banking sectors. The measures ranged from the instruments provided for in the Capital Requirements Regulation/Capital Requirements Directive IV (CRR/CRD IV) to country-specific measures. For instance, Estonia put a systemic risk buffer (SRB) in place, while the Netherlands decided to introduce both an SRB and a buffer for other systemically important institutions (O-SII buffer), with phase-in arrangements. Belgium and Slovenia introduced ad hoc measures to address country-specific aspects of systemic risk, namely excessive trading activities of banks (Belgium) and funding liquidity (Slovenia).

*… including Belgium…*

In December 2013, **Belgium** decided to apply targeted Pillar 2 capital surcharges to banks' trading activities above a certain threshold. Prior to the recent crisis, a number of Belgian banks' trading activities were undesirably high. Although banks have since reduced their trading activities, the purpose of the surcharge is to deter banks from engaging in an undesirable level of trading activity, such as that observed prior to the crisis, and to ensure that trading activities do not become a significant obstacle to banks' solvency. The surcharge is to be applied if a bank exceeds the threshold set for either of two indicators, a volume-based indicator and a risk-based indicator. The volume-based indicator consists of all held-for-trading assets that are not used for hedging the banks' own positions. If the volume-based indicator exceeds the mark of 15% of the bank's total assets, a capital surcharge equal to the amount by which the indicator exceeds the threshold will be applied. The risk-based indicator consists of the regulatory capital requirements for market risk (excluding foreign exchange risk). A capital surcharge will be applied if the "adjusted" market risk capital requirement exceeds 10% of total regulatory capital requirements, and the surcharge will equal three times the amount by which market risk capital requirements exceed the threshold. The thresholds of the indicators were determined on the basis of banks' trading activities in the pre-crisis period. The measure is not subject to any predefined time limit.

*… the Netherlands…*

The **Netherlands** decided in April 2014 to require an O-SII buffer of 1-2% for the most systemically important banks in the country, and an SRB of 3% for all Dutch banks with a balance sheet size (on and off-balance-sheet items) equal to at least 50% of the country's annual gross domestic product (GDP), with the higher of the two requirements applying to each of the credit institutions concerned. As a result, a capital buffer of 3% of the respective risk-weighted assets (CET1 capital) was imposed for ING Bank, Rabobank and ABN AMRO, while one of 1% was required of SNS Bank. Banks are able to phase in these buffers between 2016 and 2019. This will raise future CET1 capital levels required of the three major banks to at least 10% of their risk-weighted assets, and that required of SNS Bank to 8%. The reasons for the imposition of these requirements are to be found in the relatively large size of the Dutch banking sector, in terms of GDP, and its level of concentration. To determine which banks are systemically important, De Nederlandsche Bank (DNB) assessed banks against a number of criteria such as the size of a bank relative to Dutch GDP, a bank's interconnectedness with other financial institutions and the substitutability of certain crucial functions performed by a bank. On the basis of these criteria, DNB determined that ING Bank, Rabobank and ABN AMRO are the systemically most important banks. The size of the balance sheet of each individual major bank is in excess of 50% of Dutch GDP – in the case of ING Bank and Rabobank, the size actually exceeds 100% of GDP. The three major banks are also strongly interconnected, and are interwoven with other Dutch and international financial institutions. Finally, taken together, they are responsible for most lending to Dutch households (85%) and companies (60%). Although SNS Bank is far smaller and has a smaller share in the services provided to the real economy, it is likewise systemically important: it holds a relatively large proportion of Dutch consumers' savings, and part of these savings is guaranteed under the deposit guarantee scheme. In addition, SNS Bank is an important player in the domestic mortgage loan market.

*… Slovenia…*

**Slovenia** decided in April 2014 to introduce minimum requirements on changes in loans to the non-banking sector relative to changes in non-banking sector deposits. The ratio is calculated on changes in stocks before considering impairments (gross loan-to-deposit flows). The measure was introduced to counter the observed acceleration of the decline in banks' loan-to-deposit ratios in recent years (from a peak of 162% in 2008 to 130% in 2012, and further to 109% at the end of 2013), which was in turn accompanied by a decline in commercial wholesale funding and the contraction of the banking system's total assets. By way of this measure, Banka Slovenije aims to stabilise the funding structure of the banking system and mitigate system-wide funding liquidity risk, as well as to restrict negative feedback between the condition of banks, real sector activity, system-wide liquidity and loan quality. Banka Slovenije expects the measure to reduce the migration of, and competition for, deposits. The calibration of gross loan-to-deposit flows was based on historical experience and simulations for individual banks. The minimum requirements set the floor for the measure as follows: 0% in the first year, and 40% in the second year. The instrument is being introduced on a temporary basis, until the banks' funding structure has been stabilised successfully, and until system-wide funding liquidity risk has been reduced. Since the measure is to apply solely to banks in Slovenia, scope for cross-border spillover effects is very limited.

*… and Estonia*

**Estonia** decided in May 2014 to set up a systemic risk buffer requirement of 2%, starting on 1 August 2014. The systemic risk buffer applies to all credit institutions licensed in Estonia. In Eesti Pank's assessment, the main reasons for introducing the systemic risk buffer were the structural vulnerabilities of both the Estonian economy and its financial sector. The former stems primarily from the small size and from the openness of the Estonian economy. The ongoing convergence and build-up of a capital stock make the development of the economy more volatile than that of most other EU countries. Moreover, in Eesti Pank's view, the financial buffers of the real economy, although growing, are still relatively small and provide only limited protection against sudden shocks, particularly external shocks. The structural vulnerabilities of the financial sector include the high concentration of the banking sector and the exposures of institutions to the same set of economies and economic sectors, which include exposures via other subsidiaries of parent banking groups. Although the direct exposures of credit institutions in Estonia to one another may be considered to be fairly limited, the structure of their credit portfolios indicate either that they have significant direct exposures to the domestic real sector or that they are likely to be significantly affected through second-round effects if a bank with a significant market share should fail to provide services. As the total capital requirement in Estonia was set at 10% from 1997 to 2013, and as all banks there fulfilled the requirement with a sufficient excess at the end of 2013, the introduction of the measure is expected to have an only limited impact both on the capitalisation of banks and on the financing conditions of the real economy.

### REAL ESTATE MEASURES

*Real estate measures introduced in…*

Different types of real estate measures have been adopted, with the aim of addressing unfavourable developments in property markets. Real estate typically represents a large proportion of banks' credit exposures, and of households' assets, thus making imbalances in this sector particularly important in terms of financial stability. In this regard, Belgium, Slovakia, Ireland and Estonia decided to introduce national measures to address specific risks in the property markets.

*… Belgium…*

In November 2013, **Belgium** decided to increase banks' risk weights for certain exposures through a modification of the Belgian Own Funds Regulation. This decision was a result of an analysis both of the risks to the Belgian banking sector as a result of Belgian residential mortgages and of the adequacy of the capital requirements applicable to Belgian credit institutions (in Belgium, mortgage lending is undertaken primarily by Belgian credit institutions). The analysis was motivated by the significant increase in residential mortgage lending, as well as by the potential risk of an overvaluation of real estate in Belgium in recent years. Before the change, the capital requirements applicable to residential mortgages were relatively low for credit institutions relying on internal risk models (i.e. those using internal ratings-based (IRB) approaches) in Belgium (on average, 9.6% of the respective asset value), and were (and continue to be) significantly lower, on average, than those applied under the Basel II framework (35%). This is due to the fact that internal risk models are calibrated on historical credit loss data, and to the absence of a major crisis in the Belgian housing market in the past. Considering the findings of the analysis, the Nationale Bank van België/Banque Nationale de Belgique (NBB/BNB) increased the capital requirements applicable to exposures secured by mortgages on residential property in Belgium through the Basel II Pillar I framework. For IRB banks, the increase was 5 percentage points, while nothing changed for banks using the standardised approach. Once this macro-prudential measure has been implemented, the average risk weight for domestic mortgage loans for Belgian IRB banks will increase to around 14.6%, which is closer to the average risk weight observed in other core European countries. The NBB/BNB decided in March 2014 to uphold the increase in the capital requirements.

*… Slovakia…*

In October 2014, **Slovakia** decided to issue a non-binding recommendation on risks related to market developments in retail lending. The measure is to be introduced to counter the rapid pace of credit growth, the significant proportion of loans with high loan-to-value ratios (LTVs) and the high proportion of housing loans used to refinance other loans which do not involve any verification of the borrower's income and which are not subject to any interest rate stress tests. The aim of the recommendation is to keep the parameters of new retail housing loans at sustainable levels, avoiding any underestimation of risks due to a higher level of competition. It provides for the share of high LTV loans (currently between 90% and 100%) to be limited to 25% in June 2015, to 20%

in March 2016, to 15% in December 2016 and to 10% in 2017. In addition, it stipulates that no new loans with LTV ratios of more than 100% should be extended. Slovakia moreover recommends that the banks impose own limits on their debt-to-income ratios and that they verify the income generated. Banks are also asked to implement interest rate testing when granting individual loans, as well as to perform portfolio stress testing for increases in interest rates and unemployment. Lending at long maturities, with progressive or deferred repayment, is not significant, but Národná banka Slovenska advises that such lending be avoided altogether. It recommends that banks take a prudential approach to loan refinancing and lending through intermediaries. The recommendation is considered a preventive step. Slovakia believes a non-binding measure to be proportionate to the current situation. Binding measures are regarded as unnecessary since the level of risks is not high. The need for additional measures will be assessed via regular follow-up procedures and reporting. The recommendation will enter into force in November 2014 (in case of LTV limits) and March 2015 (for other issues).

*… Ireland…*

In October 2014, **Ireland** proposed that regulations placing ceilings on the share of mortgage lending at both high loan-to-value (LTV) ratios and high loan-to-income (LTI) ratios be introduced. The reason for the proposed regulation is the need to increase the resilience of Irish households and banks to residential property, in the context of high exposure of these sectors to property, and given the fact that a significant share of new lending is taking place at high LTV ratios and there have been sharp movements in house prices. Moreover, property lending tends to be subject to cyclical fluctuations which are amplified if lending standards are eased. The preceding crisis has shown the need for a policy overlay that would restrict imprudent lending throughout the credit cycle. The Central Bank of Ireland has acknowledged that loans at higher LTV and LTI rates can be appropriate in certain circumstances. For this reason, instead of imposing absolute limits, Ireland has proposed proportionate limits. The proposed measures will require banks to restrict lending for principal dwelling houses (PDHs) at rates above 80% LTV to no more than 15% of the value of all new PDH loans, and to restrict lending for PDHs at rates above 3.5 times LTI to no more than 20% of that aggregate value. Furthermore, the proposed regulation provides for a lower threshold for buy-to-let (BTL) property, requiring banks to limit BTL housing loans at rates above 70% LTV to 10% of all BTL housing loans. The rationale behind adopting limits on LTV and LTI together is to be found in the fact that both measures complement each other, with the LTI addressing the borrower's loan affordability and the LTV lender's losses in the event of default. Such thresholds are aimed at ensuring a greater degree of safety around the mortgage business. The objectives of the proposed regulations are to increase the resilience of the banking and household sectors with respect to the property market and to dampen the risk of self-reinforcing dynamics between property lending and house prices. While the regulations are not yet in place, regulated lenders have been instructed to take account of the probable introduction of such a regime and to already start adapting their lending practices in anticipation of its introduction.

*… and Estonia*

In October 2014, **Estonia** announced plans to set limits on the granting of housing loans as from 2015. Eesti Pank plans to introduce three requirements targeted at the housing market: LTV ratios, debt service-to-income ratio (DSTI) limits and a maximum maturity. The LTV will be limited to 85% (90% in the case of housing loans guaranteed by the state foundation KredEx). The DSTI limit will restrict the total amount of monthly loan, lease principal and interest payments to below 50% of the borrower's net monthly income. Finally, the maximum maturity of housing loans will be set at 30 years. The requirements are to be introduced as a precautionary measure to address the potential risk of an overvaluation of the property market. Eesti Pank does not expect the new limits to tighten prevailing lending conditions. The measures will affect all banks operating in Estonia, including branches of foreign banks.

**Table 3.1 Overview of macro-prudential policy measures implemented and proposed in euro area countries since November 2013**

| Country | Measure | Summary description | Date of entry into force | Reasons for implementation |
|---|---|---|---|---|
| **Systemic risk measures** | | | | |
| Belgium | Capital surcharge for excessive trading activities | The capital surcharge will be applied as a Pillar 2 add-on if a bank exceeds the threshold set for either of two indicators, a volume-based indicator or a risk-based indicator. | December 2013 | Prevent a build-up of systemic risk |
| Netherlands | Systemic risk buffer (SRB) and buffer for other systemically important institutions (O-SII buffer) | An O-SII buffer of 1-2% for the most systemically important banks and an SRB set at 3% of the total risk exposure (consolidated basis) for all Dutch banks with a balance sheet size equal to at least 50% of Dutch GDP. For each credit institution, the higher of the two requirements applies. | Phased in from January 2016 to January 2019 | Mitigate the long-term non-cyclical systemic risk emanating from the large and concentrated banking sector in the Netherlands |
| Slovenia | Liquidity requirements | The measure is based on the gross loan-to-deposit flows ratio. The ratio required has been set at 0% in the first year and at 40% in the second year. It is a temporary measure. | June 2014 | Prevent and mitigate systemic risk emanating from an excessive maturity mismatch and from funding illiquidity |
| Estonia | Systemic risk buffer | An SRB set at 2% of the total risk exposure (consolidated and individual basis). | August 2014 | Structural vulnerabilities of the economy and financial sector |
| **Real estate instruments** | | | | |
| Belgium | Risk weights | Five percentage point add-on to risk weights of Belgian residential mortgage loans calculated by banks that use an internal ratings-based approach. | November 2013 | Increase in residential mortgage lending |
| Slovakia | Recommendation on lending criteria | Non-binding recommendation related to the risks in the housing lending market. | First phase November 2014 | Excessive credit growth and significant proportion of loans with high LTV |
| Ireland | LTV and LTI limits | Proposal for proportionate limits on LTI and LTV ratios currently under consultation: new principal dwelling house (PDH) loans at rates above 80% LTV may not exceed 15% of the total value of all new PDH lending, and new PDH loans at rates above 3.5 times LTI may not exceed 20% of the total value of new PDH lending. Buy-to-let (BTL) housing property loans at rates above 70% LTV restricted to 10% of the total value of all BTL housing property lending. | To be announced | Increase resilience of households and banks to property, given large share of high LTV loans and sharp movements in house prices. |
| Estonia | Requirements for housing loans | Introduction of requirements for housing market: LTV limits (85% and 90% in case of loans guaranteed by KredEx), debt service-to-income (DSTI) limits (50%), maximum maturity of housing loans (30 years) | Early 2015 | Address the potential risk of an overvaluation of real estate market and protect financial system against the excessive risk-taking by banks in credit booms |

## 3.4 RESHAPING THE REGULATORY FRAMEWORK FOR FINANCIAL INSTITUTIONS, MARKETS AND INFRASTRUCTURES

This section provides an overview of a number of regulatory initiatives in the banking, insurance and market spheres that are of primary importance for enhancing financial stability in the European Union (EU).

### REGULATORY INITIATIVES FOR THE BANKING SECTOR

*Work on the finalisation and calibration of certain key elements of the CRR/CRD IV is continuing*

The key elements of the regulatory requirements for financial institutions operating in the EU, as well as the framework for the supervisory review and evaluation process and the mechanism for coordinating the activities of national and EU authorities, are set out in the **Capital Requirements Regulation/Capital Requirements Directive IV** (CRR/CRD IV). This prudential framework is complemented by the **Single Supervisory Mechanism Regulation** (SSM Regulation) that provides the ECB with strong powers for the supervision of all banks in participating Member States, as well as with additional tasks and responsibilities in the area of macro-prudential policy. While many elements of the CRR/CRD IV package are already in force, some remaining elements are still subject to finalisation and calibration, including the liquidity regulation, the leverage ratio provisions and the securitisation rules.

The international framework for **liquidity regulation** includes two policy instruments, namely the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR). The LCR is aimed at promoting the short-term resilience of the liquidity risk profile of banks, while the NSFR is aimed at diminishing maturity mismatches between assets and liabilities, thereby reducing funding risks of banks. Since the publication of the final definition of the LCR by the Basel Committee in January 2013, the European Commission has made significant progress with respect to the implementation of this liquidity standard in the EU. A key element of this process was the publication of the final delegated act on the LCR in October 2014.[9] The remaining work primarily concerns the scope of supervisory reporting before the LCR is phased in next year, with an initial minimum requirement of 60%.

As regards the NSFR, the Basel Committee published a consultative document on a revised calibration of the measure in January 2014, also aligning the NSFR with the LCR in terms of the treatment of high-quality liquid assets. In the European context, the European Banking Authority (EBA) has set up a team to assess the impact and appropriate calibration of the NSFR. A final report by the EBA is expected to be delivered to the European Commission by the end of 2015.

The ECB actively supports the ongoing work on the **leverage ratio** that is aimed at preventing the build-up of excessive leverage in the financial system. Following the endorsement of the revised definition of the leverage ratio by the governing body of the Basel Committee in January 2014, the Group of Central Bank Governors and Heads of Supervision (GHOS), the European Commission issued a delegated act that broadly aligns the CRR/CRD IV definition with the revised international standard. As regards the implementation of the leverage ratio as a supervisory tool, banks will be required to publicly disclose their leverage ratios as from January 2015.[10]

9 See the Commission Delegated Regulation of 10 October 2014 (available at: http://ec.europa.eu).
10 See Special Feature C in this issue of the FSR for further details on the NSFR.

*The concept of "simple and transparent securitisation" is spreading ever faster at both the global and the EU level*

In the area of **securitisation**, significant work is underway at the global and EU levels. This stems from the policy objective of reviving securitisation markets in a sustainable manner, and reflects the positive effects that sound securitisation practices can have on the financing of the real economy.

At the international level, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) set up a Task Force on Securitisation Markets earlier this year, with the aim of (i) identifying factors that may be hindering the development of sustainable securitisation markets and the participation of certain types of investors, and (ii) defining criteria to identify and assist in the development of simple and transparent securitisation structures.[11] These criteria could inform future regulatory actions, such as those of the BCBS, which pledged, at its meeting in September 2014, to consider in 2015 how to incorporate the BCBS-IOSCO criteria, once finalised, into the securitisation capital framework.[12]

In the EU in October, the European Commission adopted two delegated acts under the Solvency II Directive and – for the LCR – the CRR that establish a differentiated regulatory treatment of securitisations that meet certain criteria in terms of simplicity and transparency. In addition, following a call for advice from the European Commission on the appropriateness of the prudential requirements provided for in the CRR/CRD IV in relation to long-term financing and, in particular, securitisations, the EBA determined that certain simple, standard and transparent securitisations merit differentiated capital treatment, developed draft criteria to identify such securitisations and launched a public consultation that is to be closed in mid-January 2015.[13]

Notwithstanding the ongoing work on the above-mentioned prudential requirements, several policy tools are already available for also macro-prudential purposes. Subject to strict notification and coordination mechanisms between national and EU authorities, including the ECB under the SSM Regulation, the CRR/CRD IV defines a set of instruments that can be applied by macro-prudential authorities to address risks to financial stability.

As required by the CRR, the revision by the European Commission of the **macro-prudential rules** is an ongoing process. The revision is focusing on the assessment of the effectiveness, efficiency and transparency of the policy framework and on the adequacy of the coverage of, and possible overlap between, tools, as well as on the interaction between internationally agreed standards and the provisions of the CRR/CRD IV.

The European Systemic Risk Board (ESRB) and the EBA have already provided the Commission with their assessment of the adequacy of the macro-prudential policy framework and have set out a number of proposals with regard to possible ways of improving the framework. The ECB, too, is currently assessing the adequacy of the macro-prudential rules in the CRR/CRD IV, with a specific focus on identifying the main issues arising from the establishment of the SSM and on ensuring consistency between the SSM Regulation and the CRR/CRD IV.

With regard to recently passed legislation or ongoing regulatory initiatives, Tables 3.2 to 3.4 provide an update of the major strands of work in the EU, followed by a short overview of selected policy measures from the perspective of financial stability and macro-prudential policy.

11 See the BCBS-IOSCO press release of 3 July 2014 (available at: http://www.bis.org/press/p140703.htm).
12 See BCBS press release (available at: http://www.bis.org/press/p140925.htm).
13 See EBA, "EBA Discussion Paper on simple, standard and transparent securitisations", 14 October 2014.

**Table 3.2 Selected new legislation and proposals for legislative provisions on the banking sector in the EU**

| Initiative | Description | Current status |
|---|---|---|
| Single Supervisory Mechanism Regulation (SSM Regulation) | The SSM Regulation establishes a Single Supervisory Mechanism (SSM) with strong powers for the ECB (in cooperation with national competent authorities) for the supervision of all banks in participating Member States (euro area countries and non-euro area Member States which join the system). | The SSM came into force on 4 November 2014, and the ECB took up its new role of supervisor. The results of the comprehensive assessment of all banks that are under its direct supervision were published on 26 October 2014. |
| Bank Recovery and Resolution Directive (BRRD) | The BRRD sets out a framework for the resolution of credit institutions and investment firms, with harmonised tools and powers relating to prevention, early intervention and resolution for all EU Member States. | The BRRD entered into force on 2 July 2014. Member States have to transpose the BRRD into national legislation by 31 December 2014, and to apply it as from 1 January 2015. However, the bail-in provisions will only be applicable as of 1 January 2016, at the latest. |
| Deposit Guarantee Scheme Directive (DGS Directive) | The DGS Directive deals mainly with the harmonisation and simplification of rules and criteria applicable to deposit guarantees, a faster pay-out, and an improved financing of schemes for all EU Member States. | The DGS Directive entered into force on 2 July 2014. Member States will have to transpose most provisions into national legislation by 3 July 2015, and in full by 31 May 2016. |
| Single Resolution Mechanism Regulation (SRM Regulation) | The SRM Regulation establishes a single system, with a single resolution board and single resolution fund, for an efficient and harmonised resolution of banks within the SSM.<br>The SRM would be governed by two main legal texts: the SRM Regulation, which covers the main aspects of the mechanism, and an Intergovernmental Agreement (IGA) relating to some specific aspects of the Single Resolution Fund (SRF). | The SRM Regulation entered into force on 19 August 2014. It will be partly applicable as of 1 January 2015, whereas most resolution functions (including the SRF) will apply as from 1 January 2016 (or when the IGA becomes applicable, if later).<br>The IGA on the SRF was signed by all Member States (except the United Kingdom and Sweden) on 21 May 2014, and its ratification by national parliaments is now pending. |
| Regulation on structural measures | The Regulation introduces restrictions on certain activities and sets out rules on structural separation, with the aim of improving the resilience of EU credit institutions. | The European Commission's proposal was published on 29 January 2014. Preliminary discussions have started in the European Council. The ECB's legal opinion on the proposal was published on 21 November 2014. |

*Significant progress made in the establishment of the banking union*

Another key area of significant progress comprises steps taken towards a banking union in Europe, namely the establishment of (i) a single supervisory mechanism, (ii) a single resolution framework, (iii) a single resolution mechanism and (iv) harmonised deposit insurance. The first pillar of the banking union, the **Single Supervisory Mechanism** became operational on 4 November.

*The BRRD will provide common and efficient tools and powers for addressing a banking crisis*

Important complementary elements of single supervisory arrangements are a common EU framework for bank recovery and resolution, as well as a single resolution mechanism. As of 1 January 2015, the **Bank Recovery and Resolution Directive** (BRRD) will be implemented by all Member States.[14] The BRRD establishes common and efficient tools and powers for addressing a banking crisis pre-emptively, and for managing failures of credit institutions and investment firms in an orderly manner throughout the EU.

14 With the exception of the bail-in tool, which will follow by 1 January 2016 at the latest.

*The SRM will create a single system for resolution*

The **Single Resolution Mechanism** (SRM) will establish a single system, with a Single Resolution Board (SRB) and a Single Resolution Fund (SRF) at its centre, for the resolution of banks in Member States participating in the SSM. The SRM is a necessary complement to the SSM in order to achieve a well-functioning banking union and to sever the link between banks and their sovereigns. Thus, the SRM will apply to all banks supervised within the scope of the SSM, and accordingly, any Member State outside the euro area which opts to join the SSM will automatically also fall under the SRM. The SRM will ensure that in the event of a bank failing, and if it is in the public interest to resolve it, its resolution can be managed efficiently, jointly and in the common interest. The SRM will be better placed to take due account of contagion and spillovers when making resolution decisions. It will also ensure a consistent application of resolution principles and tools throughout the banking union, also for banks with no cross-border activity.

The SRM will be governed by two main legal texts: (i) the SRM Regulation, which covers the main aspects of the mechanism and is based on the BRRD, and (ii) an Intergovernmental Agreement (IGA), which covers some specific aspects of the SRF. Whereas most of the provisions of the SRM Regulation will apply as from 1 January 2016, the SRB will become operational on 1 January 2015. This will allow the SRB to engage in recovery and resolution planning during 2015.[15] The European Commission is responsible for the establishment of the SRB, and a dedicated Commission Task Force has been set up for this purpose.

The IGA on the transfer and mutualisation of contributions to the SRF was signed by 26 Member States.[16] All signatories of the IGA are to complete its ratification according to their national procedures before 1 January 2016. This is expected to take place soon, given that the Commission has recently adopted a delegated act and a proposal for a Council implementing act on the risk-based bank contributions to national resolution funds and the SRF, as required by the BRRD and the SRM Regulation respectively.

15 This may include, for example, the examination of recovery plans received from the ECB or national competent authorities in order to identify any actions which may adversely impact the resolvability of the institutions, and the drafting and adoption of resolution plans, including the assessment of resolvability, the application of simplified obligations for certain institutions and the determination of the minimum requirements of eligible liabilities and own funds for bail-ins, for all covered institutions.
16 The IGA was signed by all Member States except the United Kingdom and Sweden.

**Box 6**

## REGULATORY INITIATIVES TO ENHANCE OVERALL LOSS-ABSORPTION CAPACITY

One of the key objectives of the resolution frameworks introduced in response to the recent crisis, such as the Bank Recovery and Resolution Directive (BRRD) in the EU, is the shifting of the cost of bank failures from the taxpayer to, first and foremost, the shareholders and creditors of the failing bank. This is important for many reasons, not least that of solving the too-big-to-fail problem of large banks, which – unless there is a credible resolution option – often have to be bailed out by the public at huge cost. These banks have often been perceived by markets as having an implicit state guarantee, which creates not only a moral hazard problem, but also an uneven playing field among banks, in that large banks in fiscally strong countries can fund themselves far more cheaply than smaller banks or banks in countries with weaker public finances. Thus, the introduction of a credible resolution framework contributes to weakening the link between banks and their sovereigns, which proved to be both costly and destabilising in the recent crisis.

An important tool for attaining this objective is the bail-in tool, which enables the resolution authority to write down, or convert into equity, the claims of a broad range of creditors. However, some types of liabilities are excluded from the scope of a bail-in, such as secured liabilities and covered deposits. Furthermore, in exceptional circumstances, other liabilities may also have to be excluded on a case-by-case basis, either because it is not possible to bail them in quickly enough or because this is necessary in order to attain the resolution objectives. Consequently, in order to ensure that the bail-in tool will still be efficient in resolution, there is a need to make sure that there are sufficient own funds and liabilities in banks for bail-ins, when needed.

Under the BRRD, Member States are required to ensure that institutions meet a minimum requirement for own funds and eligible liabilities (MREL) for bail-ins.[1] An adequate level of own funds and eligible liabilities will be key to ensure that there is sufficient loss-absorbing capacity within institutions when they fail, thereby underpinning the efficient application of the bail-in tool. It will also protect the resolution funds, including the Single Resolution Fund, as own funds and eligible liabilities, as defined by the MREL, and other bail-inable liabilities will be used before a resolution fund may contribute to the funding of any resolution.

Some technical details on the MREL remain to be finalised before it becomes operational along with the bail-in tool in 2016. In particular, the European Banking Authority will draft regulatory technical standards by July 2015 which will specify how the MREL is to be determined for each institution. By December 2016, the European Commission will submit a legislative proposal on the harmonised application of the MREL. Such a proposal may include the introduction of an appropriate number of different MRELs that take account of the different business models of institutions and groups, as well as possible adjustments to ensure consistency with any international standards that have been developed by international fora in this area.

Currently, an international standard is also under discussion within the G20 and the Financial Stability Board (FSB) so as to end the too-big-to-fail problem of the global systemically important banks (G-SIBs). The FSB, in consultation with the Basel Committee on Banking Supervision, has developed proposals on the adequacy of loss-absorbing capacity of G-SIBs in resolution, in response to a call by G20 leaders at the 2013 St Petersburg summit. The proposal is subject to public consultation and a quantitative impact study, before being finalised by the FSB in 2015. This proposal would be the international equivalent of the MREL in the BRRD, applicable to G-SIBs only. Although similar, the draft FSB proposal for G-SIBs' total loss-absorbing capacity (TLAC) in resolution differs from the MREL in some key areas (see the table below).

**Key features of the MREL and the TLAC**

| | MREL | TLAC |
|---|---|---|
| Scope | All banks in scope of the BRRD | G-SIBs only |
| Set-up | A minimum requirement in parallel to Basel III minimum capital requirements for banks, calculated as the amount of own funds (including buffers) and eligible liabilities. | A minimum requirement incorporating Basel III minimum capital requirements and excluding Basel III buffers for G-SIBs. |

1 Within the SRM, the SRB will be the authority, after consulting competent authorities, including the ECB, which determines the MREL for all entities under direct ECB supervision and for all cross-border groups.

## Key features of the MREL and the TLAC (cont'd)

| | MREL | TLAC |
|---|---|---|
| Determination | Determined on an individual basis for each institution. | A common minimum Pillar 1 requirement set within the range of 16-20% of RWAs and at least twice the Basel III Tier 1 leverage ratio requirement[1] as a floor for all G-SIBs, with the possibility for authorities to top it up on an individual basis through a Pillar 2 component. Also sets out how TLAC is distributed among material institutions within a group when the whole group is resolved or when various sub-sets of the group are resolved together. |
| Eligible instruments | Capital instruments can simultaneously satisfy both minimum regulatory capital requirements (including buffers) and the MREL. To be eligible, liabilities need to fall within the scope of bail-in. This will exclude e.g. covered deposits and, in principle, secured liabilities. Additionally, eligible liabilities must satisfy certain criteria, such as issued and fully paid up, not owed to, secured or guaranteed by the institution itself, not arise from a derivative or from a preferred deposit, and have a remaining maturity of at least one year. | Capital instruments can simultaneously satisfy both minimum regulatory capital requirements and TLAC, but only CET1 capital in excess of that required to satisfy these requirements may count towards the capital buffers. Certain liabilities are excluded from consideration for TLAC, e.g. liabilities arising from derivatives, insured deposits and liabilities which are preferred to normal senior unsecured creditors under the relevant insolvency law. Eligible external TLAC must be unsecured, must have a minimum remaining maturity of at least one year and must not be subject to set off or netting rights. Credible ex ante commitments by authorities to recapitalise a G-SIB, which may be required to contribute to resolution funding, may count towards a firm's Pillar 1 minimum TLAC, subject to certain strict conditions (e.g. the commitments must be pre-funded by industry contributions). |
| Priority | Priority is not a precondition in the BRRD. | Eligible external TLAC must absorb losses prior to excluded liabilities in insolvency or in resolution without giving rise to material risk of successful legal challenge or compensation claims. |
| Regulation of investors | Without prejudice to the existing large exposure regime Member States have to ensure that in order to provide for resolvability of institutions/groups, resolution authorities limit the extent to which other institutions hold liabilities eligible for the bail-in tool, save for liabilities that are held at entities that are part of the same group. | G-SIBs must deduct from their own TLAC or regulatory capital exposures to eligible external TLAC liabilities issued by other G-SIBs in a manner generally parallel to the existing provisions in Basel III that require a bank to deduct from its own regulatory capital certain investments in the regulatory capital of other banks. Further provisions, also for non G-SIBs, are envisaged. |

1) The calibration is subject to a quantitative impact study and market survey which will be carried out in early 2015.

*Improved depositor protection in the EU*

A final element of the banking union is the establishment, in the medium term, of a common deposit guarantee fund in the EU. A first step in this direction was the entry into force of the recast **Deposit Guarantee Scheme Directive** (DGS Directive) on 2 July 2014.[17]

17 By 3 July 2019, the Commission must submit a report and, if appropriate, a legislative proposal to the European Parliament and the Council, setting out how deposit guarantee schemes operating in the EU may cooperate through a European scheme so as to prevent risks from arising from cross-border activities and to protect deposits against such risks.

The DGS Directive will ensure that deposits in all Member States will continue to be guaranteed up to an amount of €100,000 per depositor and bank. It will also ensure faster pay-outs with specific repayment deadlines, which will gradually be reduced from 20 to 7 working days by 2024. It will also ensure a strengthened financing of deposit guarantee schemes, notably by requiring a significant level of ex ante funding (0.8% of covered deposits) which is to be met within ten years. At most 30% of the funding could be made up of payment commitments. In case of insufficient ex ante funds, the deposit guarantee scheme would collect immediate ex post contributions from the banking sector and, as a last resort, the scheme would have access to alternative funding arrangements, such as loans from public or private third parties. In addition, a voluntary mechanism for mutual borrowing between national deposit guarantee schemes in the EU is also provided for.

*The proposal for a Regulation on structural measures aims at improving the resilience of European banks*

On 29 January 2014, the European Commission presented its proposal for a **Regulation on structural measures for EU credit institutions**. The proposal aims at improving the resilience of European banks by preventing contagion from banks' trading activities to traditional banking activities. This would be done by prohibiting banks from carrying out proprietary trading, i.e. securities trading not related to client activity or hedging, and only for the purpose of making a profit for their own account. Furthermore, it is proposed that supervisors can require a bank to shift other trading activities to trading entities, which are legally, economically and operationally separated from the deposit-taking entity of the bank. Importantly, trading in government bonds issued by Member States will be exempted from the prohibition, as well as from the separation requirements. Likewise, the deposit-taking entity will still be able to use financial instruments aimed at hedging its own risks. The regulation will cover all global systemically important banks in the EU, as well as other banks with sufficiently large trading activities.

Another key objective of this proposal is to reduce banks' incentives to take excessive risks on the back of the safety net (resolution funds, deposit insurance funds and, ultimately, governments), and to make banks less complex to resolve. In ensuring that, the proposal can complement the BRRD and may, at the same time, contribute to enhancing systemic stability in Europe. Also, by harmonising rules on structural regulation, the proposal seeks to create a level playing field for banks inside the EU.

The ECB supports this proposal in principle. It will contribute towards ensuring a harmonised EU framework that addresses concerns related to banks that are "too big to fail" and "too interconnected to fail". Nevertheless, the ECB considers it important to sufficiently preserve the market-making activities of banks in order to maintain or increase asset and market liquidity, to moderate price volatility and to increase securities markets' resilience to shocks.

### REGULATORY INITIATIVES FOR FINANCIAL MARKETS AND INFRASTRUCTURES

In addition to initiatives in the area of banking regulation, several steps have been taken to also strengthen the resilience of **financial infrastructures**.

*Adoption of an ECB Regulation on oversight requirements for systemically important payment systems*

The **ECB Regulation on oversight requirements for systemically important payment systems** came into force on 12 August 2014. The Regulation aims to ensure the efficient management of legal, credit, liquidity, operational, general business, custody, investment and other risks, as well as sound governance arrangements, objective and open access and the efficiency and effectiveness of systemically important payment systems (SIPSs). It implements the principles for financial market infrastructures (PFMIs) developed jointly by the Committee on Payments and Market Infrastructures and IOSCO in a legally binding way, and covers both large-value and retail payment systems of systemic importance, irrespective of whether they are operated by Eurosystem national central banks or private entities. Four SIPSs have been identified: TARGET2 (operated by the Eurosystem), EURO1 and STEP2 (both operated by EBA Clearing), and CORE (FR) (operated by STET). The Eurosystem will review this list on the basis of updated statistical data each year. For consistency with international practices, and to take account of the increased integration of retail payment systems in the Single Euro Payments Area (SEPA), the Eurosystem has also undertaken a comprehensive review of the oversight standards for euro retail payment systems that are not SIPSs. As a result of this review, the ECB published the "Revised Oversight Framework for Retail Payment Systems" on 21 August 2014.

**Table 3.3 Selected new legislation and legislative proposals for financial markets and infrastructures in the EU**

| Initiative | Description | Current status |
|---|---|---|
| ECB Regulation on oversight requirements for systemically important payment systems | The Regulation aims at ensuring the efficient management of all types of risk that systemically important payment systems (SIPSs) face, together with sound governance arrangements, objective and open access, as well as the efficiency and effectiveness of SIPSs. | The Regulation entered into force on 12 August 2014. |
| European Market Infrastructure Regulation (EMIR) | The Regulation aims to bring more safety and transparency to the over-the-counter derivatives market and sets out rules for, inter alia, central counterparties and trade repositories. | The Regulation entered into force in August 2012. Implementation is in progress. |
| Regulation on improving the safety and efficiency of securities settlement in the EU and on central securities depositories (CSD Regulation) | The Regulation introduces an obligation of dematerialisation for most securities, harmonised settlement periods for most transactions in such securities, settlement discipline measures and common rules for central securities depositories. | The Regulation entered into force on 17 September 2014. Implementation is in progress. |
| Review of the Markets in Financial Instruments Directive and Regulation (MiFID II/MiFIR) | The legislation will apply to investment firms, market operators and services providing post-trade transparency information in the EU. It is set out in two pieces of legislation: a directly applicable regulation dealing, inter alia, with transparency and access to trading venues, and a directive governing authorisation and the organisation of trading venues and investor protection. | The Directive 2014/65/EU on markets in financial instruments (MiFID II) and the Regulation (EU) No 600/2014 on markets in financial instruments (MiFIR) were both published in the Official Journal of the EU on 12 June 2014. |
| Proposal for a Money Market Fund Regulation (MMF Regulation) | The proposal addresses the systemic risks posed by this type of investment entity by introducing new rules aimed at strengthening their liquidity profile and stability. It also sets out provisions that seek, inter alia, to enhance their management and transparency, as well as to standardise supervisory reporting obligations. | The European Commission's proposal was published in September 2013 and has since been subject to discussions at the trialogue level by the European Parliament and, lately, by the European Council. |
| Proposal for a Regulation on reporting and transparency of securities financing transactions | The proposal contains measures aimed at increasing the transparency of securities lending and repurchase agreements through the obligation to report all transactions to a central database. This seeks to facilitate regular supervision and to improve transparency towards investors and on re-hypothecation arrangements. | The European Commission's draft proposal was published in January 2014. The ECB expressed its support, in principle, of the proposal in its legal opinion of 24 June 2014. |

Implementation of the **European Market Infrastructure Regulation** (EMIR) has continued to make progress. The Regulation seeks to bring more stability, transparency and efficiency to derivatives markets by requiring, inter alia, standard derivative contracts to be cleared through central counterparties (CCPs), and all European derivative transactions to be reported to trade repositories. CCPs that were previously authorised in a Member State had to apply for authorisation under EMIR by 15 September 2013. On 18 March 2014, the first EU CCP was authorised under EMIR. In the meantime, further EU CCPs that had filed an application have been authorised to offer services and conduct activities in the EU.[18] The first authorisations of CCPs under EMIR have set in motion the process of determining the classes of derivatives subject to the mandatory clearing obligation. The European Securities and Markets Authority (ESMA) submitted final draft regulatory standards on the clearing obligation to the European Commission in October 2014, covering several classes of over-the-counter (OTC) interest rate derivatives. Mandatory clearing of these products will enter into force gradually as from 2015. The Eurosystem complements EMIR and uses the PFMIs as its oversight standards for CCPs.

The Regulation on improving securities settlement in the EU and on **central securities depositories** (the CSD Regulation) entered into force on 17 September 2014. The aim of the Regulation is to increase the safety and efficiency of securities settlement and settlement infrastructures (i.e. central securities depositories – CSDs) in the EU. It introduces, inter alia, an obligation of dematerialisation for most securities, harmonised settlement periods for most transactions in such securities, settlement discipline measures and common rules for CSDs. The CSD Regulation enhances the legal and operational conditions for cross-border settlement in the EU. It delegates to ESMA and the EBA the drafting, in close cooperation with the members of the ESCB, of technical standards within nine months of its entry into force (i.e. before end-June 2015). The PFMIs complement the provisions of the CSD Regulation with respect to the Eurosystem's oversight standards.

*The FSB makes further progress with its shadow banking agenda*

In the field of **shadow banking**, the FSB carried on with the deliverables agreed at the G20 Summit in St Petersburg in 2013, with a view to presenting an updated roadmap in time for the Brisbane Summit on 15-16 November 2014. Milestones attained in the last six months include:[19]

(i) The publication in October of a revised regulatory framework on haircuts for non-centrally cleared short-term financing transactions to limit the build-up of excessive leverage outside the banking system and help reduce pro-cyclicality.[20] The framework includes a consultative proposal on the application of numerical haircut floors to transactions between non-banks.

(ii) The review of standards and processes for global securities financing data collection and aggregation ahead of their planned public consultation.

(iii) The approval of a work plan to examine a possible harmonisation of regulatory approaches to re-hypothecation of client assets and possible financial stability issues related to collateral re-use.

18 An up-to-date list of authorised CCPs can be found on ESMA's website at: http://www.esma.europa.eu/content/Registries-and-Databases.
19 See the FSB press release issued following the FSB Plenary Meeting on 17 and 18 September 2014 in Cairns, Australia (available at: https://www.financialstabilityboard.org/press/pr_140918.htm).
20 See the FSB press release of 14 October 2014 (available at: https://www.financialstabilityboard.org/press/pr_141013.htm).

The FSB intends, in 2015, to launch a peer review of the jurisdictional implementation of the high-level policy framework for strengthening oversight and regulation of shadow banking entities (other than MMFs).

### REGULATORY INITIATIVES FOR THE INSURANCE SECTOR

*Progress made with the technical implementation of the Solvency II regime*

The **Solvency II Directive** will harmonise the different regulatory regimes for insurance corporations in the European Economic Area and will introduce risk-based capital requirements for the first time. After the adoption by the Council of the Omnibus II Directive, which amends the Solvency II Directive, the European Commission and the European Insurance and Occupational Pensions Authority (EIOPA) are working on rules and guidelines to specify more detailed requirements for individual undertakings, as well as for groups. In October, the Commission published the Solvency II Delegated Act, which covers the scope of the valuation of assets, capital requirements, governance, group supervision, third country equivalence, and reporting and public disclosure. The Delegated Act also sets out the details on the favourable treatment of long-term guarantee activities as agreed in the Omnibus II Directive, as well as details on the preferential regulatory treatment of high-quality securitisations. EIOPA is working on Implementing Technical Standards (ITSs) and Guidelines on Solvency II to ensure its uniform application. EIOPA has divided the ITSs and Guidelines into two sets. A first set of ITSs and Guidelines was submitted to the Commission on 31 October. A second set is scheduled to be published for consultation in December 2014, and is expected to be finalised by the middle of next year, before Solvency II is applied in 2016.

*Development of group-wide global insurance capital standards*

At the international level, the International Association of Insurance Supervisors (IAIS) has decided to identify, for 2014, the nine **global systemically important insurers** (G-SIIs) identified in 2013. A set of policy measures, such as higher loss absorbency (HLA), will apply to those insurers. As a basis for the HLA, the basic capital requirements (BCRs) for G-SIIs are currently being developed by the IAIS. The simple, factor-based BCRs will be replaced by a risk-sensitive global insurance capital standard (ICS) from 2019. The ICS will be applied not only to G-SIIs, but also to the wider group of internationally active insurance groups.

**Table 3.4 Selected legislative proposals for the insurance sector in the EU**

| Initiative | Description | Current status |
|---|---|---|
| Solvency II Directive/Omnibus II Directive | The Solvency II Directive is the framework directive that aims to harmonise the different regulatory regimes for insurance corporations in the European Economic Area. Solvency II includes capital requirements, supervision principles and disclosure requirements.<br>The Omnibus II Directive aligns the Solvency II Directive with the legislative methods introduced by the Lisbon Treaty, incorporates new supervisory measures given to the European Insurance and Occupational Pensions Authority (EIOPA) and makes technical modifications. | The Solvency II Directive was adopted by the EU Council and the European Parliament in November 2009. It is now scheduled to come into effect on 1 January 2016.<br>The European Commission has published the Delegated Act on Solvency II. EIOPA has submitted a first set of Implementing Technical Standards (ITSs) on approval processes and "Guidelines" relevant for approval processes, including Pillar 1 (quantitative basis) and internal models. |

### OTHER INITIATIVES

Finally, an issue closely related to financial regulation is the proposal published by the European Commission on 14 February 2013 for implementing a financial transaction tax (FTT) in 11 euro area Member States via enhanced cooperation. The European Parliament adopted a legislative resolution on the proposal, in which it supports the Commission's proposal but calls for several amendments. The negotiations among Member States are continuing in the meantime. On 6 May 2014, new political impetus was given in a joint statement by ten ministers, issued in the context of the ECOFIN Council meeting. The statement envisages a staged approach (first equities and some derivatives, followed by other instruments at a later stage) and foresees that a first step of FTT implementation will enter into force in 2016.

Legislative proposals on tax policies do not fall within the fields of competence of the ECB. However, the ECB is monitoring the legislative process closely in view of the possible impact of the FTT on financial markets, financial market infrastructures, monetary policy implementation and financial stability.