ECB-PUBLIC

COURTESY TRANSLATION

Mario DRAGHI
President

Ms Eva Kaili
Member of the European Parliament
European Parliament
60, rue Wiertz
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Frankfurt am Main, 27 March 2019

L/MD/19/84

Re: Your letter (QZ-002)

Honourable Member of the European Parliament, dear Ms Kaili,

In your letter to Mr Andrea Enria, Chair of the ECB's Supervisory Board, which was passed on by Mr Roberto Gualtieri, Chair of the European Parliament's Committee on Economic and Monetary Affairs, with a cover letter dated 16 January 2019, you enquired about issues beyond the scope of the ECB's supervisory tasks. Consequently, Mr Enria forwarded your letter to me.

As you point out in your letter, since the financial crisis in 2008 the supervisory architecture has been reformed and a range of policy measures have been taken to improve the resilience of the financial system. Many of these policy measures have been introduced for banks, but considerable progress has also been made in strengthening the EU's regulatory and supervisory framework for non-bank financial institutions, also with the aim of addressing risks from shadow banking.

Importantly, several new rules for the banking sector have been developed with the aim of capturing risks, including those related to concentration, that emanate from off-balance-sheet and non-bank activities. Prominent examples include: (i) the leverage ratio, which captures both on-balance-sheet and off-balance-sheet items; (ii) the new securitisation framework, which ensures that these activities are adequately capitalised in the banking system; (iii) the EBA guidelines on limits on exposures to shadow banking entities; and (iv) risk-sensitive capital requirements for banks' equity investments in funds.[1]

[1] For an overview of global developments in this regard, see "Assessment of shadow banking activities, risks and the adequacy of post-crisis policy tools to address financial stability concerns", Financial Stability Board, July 2017, available at http://www.fsb.org/wp-content/uploads/P300617-1.pdf.

In addition to the new rules for banks, some EU regulatory reforms to improve the resilience of non-bank financial entities and activities in the EU have been adopted. For example, the Alternative Investment Fund Managers Directive (AIFMD) and the Money Market Fund Regulation (MMFR)[2] were introduced to enhance the regulatory framework for the investment fund sector, while the European Market Infrastructure Regulation (EMIR) and the Securities Financing Transaction Regulation (SFTR) address risks stemming, respectively, from derivatives and SFT markets.

As you point out, the close monitoring of the shadow banking sector is important to identify risks emerging from non-bank financial intermediation. To this end, different processes have been introduced since the onset of the financial crisis. For example, the European Systemic Risk Board (ESRB) publishes an annual monitoring report on the shadow banking system in the EU, to which European supervisory authorities, national authorities and the ECB contribute.[3] Moreover, the ECB itself regularly communicates on its assessment of systemic risks for euro area financial stability in its semi-annual Financial Stability Review (FSR),[4] which includes developments in the non-bank financial sector.

The latest FSR highlights the importance of addressing new and emerging risks from non-bank financial intermediation, inter alia related to liquidity strains in the investment fund sector. It underlines the need to monitor the sector closely and develop the macroprudential toolkit for investment funds and other forms of non-bank finance. In particular, we see a need to extend the toolkit available to EU and national authorities, which would enable them to address risks arising from the continuously growing non-bank sector. In this context, the ECB supports targeted changes to the governance and operational framework of the ESRB as part of the ongoing ESRB review, which would further improve the coordinated response to systemic risks in the EU and enhance the ESRB's efficiency and effectiveness.

Moreover, the ECB has developed analytical tools and models to assess, on a quarterly basis, the potential risk of systemic events within the banking system. Using granular data on credit institutions' loans and securities portfolios, the ECB assesses such risks by evaluating the extent of potential losses induced by financial contagion in favourable and adverse scenarios. To this end, various channels through which idiosyncratic shocks to an individual bank can propagate at the system level are taken into account, notably secured and unsecured direct bilateral claims among banks, and common exposures to illiquid assets. On the basis of this information, the ECB estimates potential losses in the event of a default of one or several banks, and the extent of direct capital losses or the deterioration in money market conditions in the event of fire sales.

In addition, microprudential efforts aim at improving individual banks' resilience. To this end, ECB Banking Supervision defines its supervisory priorities based on an assessment of the main challenges facing supervised banks in the current economic, regulatory and supervisory environment, and aims to ensure that

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[2] In addition, the Undertakings for Collective Investment in Transferable Securities (UCITS) Directive provides a regulatory framework for retail investment funds.

[3] For the latest report, see EU Shadow Banking Monitor No 3, ESRB, September 2018, available at https://www.esrb.europa.eu/pub/pdf/reports/esrb.report180910_shadow_banking.en.pdf.

[4] See Financial Stability Review, ECB, November 2018, available at https://www.ecb.europa.eu/pub/fsr/html/index.en.html.

banks address their key risks effectively. For 2019 the key drivers of banking sector risks were identified as: geopolitical uncertainties, the stock of non-performing loans (NPLs) and potential for a build-up of future NPLs, cybercrime and IT disruptions, potential repricing in financial markets, the low interest rate environment, banks' reaction to new and existing regulations, euro area economic and fiscal conditions, cases of misconduct, developments in real estate markets, structural business challenges, non-bank competition and climate-related risks.[5]

Another aspect that deserves attention is the way forward on the regulation and supervision of large, complex, interconnected investment firms that perform bank-like activities. As these firms may pose systemic risks, it is important to ensure that their regulation and supervision is aligned with that of systemic banking institutions.[6]

Finally, efforts are also needed in the EU to implement the Basel Committee's Guidelines on the identification and management of step-in risks.[7] Step-in risks exist where banks are incentivised to provide financial support to other entities for reputational reasons, and they arise from the manifold interlinkages between banks and the shadow banking sector. Since step-in risks are generally not captured by standard capital and liquidity requirements, it is important to gain a better visibility of such interlinkages.

Yours sincerely,

[signed]

Mario Draghi

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[5] See ECB Banking Supervision: SSM Supervisory Priorities 2019, available at https://www.bankingsupervision.europa.eu/banking/priorities/html/ssm.supervisory_priorities2019.en.html.

[6] See Opinion of the European Central Bank of 22 August 2018 on the review of prudential treatment of investment firms (CON/2018/36), available at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2018_36_f_sign.pdf.

[7] See the Guidelines for the identification and management of step-in risk, Basel Committee on Banking Supervision, October 2017, available at https://www.bis.org/bcbs/publ/d423.pdf.

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