



EUROPEAN CENTRAL BANK

EUROSYSTEM

Magnus Andersson
European Central Bank

Central Bank Communication and Financial Stability

Continental Seminar of the Association of African
Central Banks

Accra 3 May 2017

Conceptual Issues

Financial stability communication

- i) Risk identification**
- ii) Resilience of the financial system**
- iii) Macroprudential policies**

Financial stability

Characteristics of a stable financial system

Financial stability is a state whereby the build-up of systemic risk is prevented.

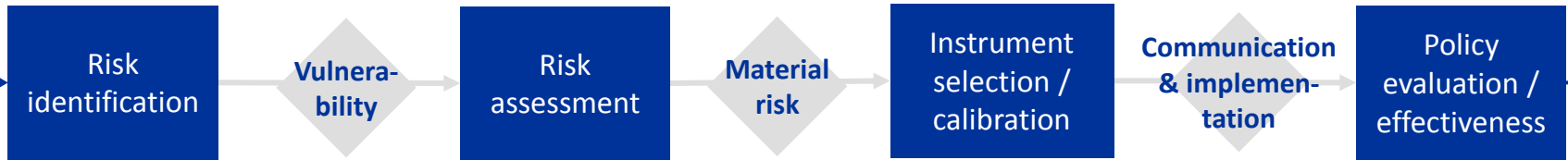
Systemic risk (Communicated in the Financial Stability Review, Foreword)

“Systemic risk can best be described as the risk that the provision of necessary financial products and services by the financial system will be impaired to a point where economic growth and welfare may be materially affected.

Macroprudential policy cycle in the ECB: Surveillance and assessment

Analytical dimension

Policy dimension



Surveillance
 Identification of potential sources of systemic risk requires an encompassing view of the financial sector
 ↓
 Potential for missing an important source of systemic risk

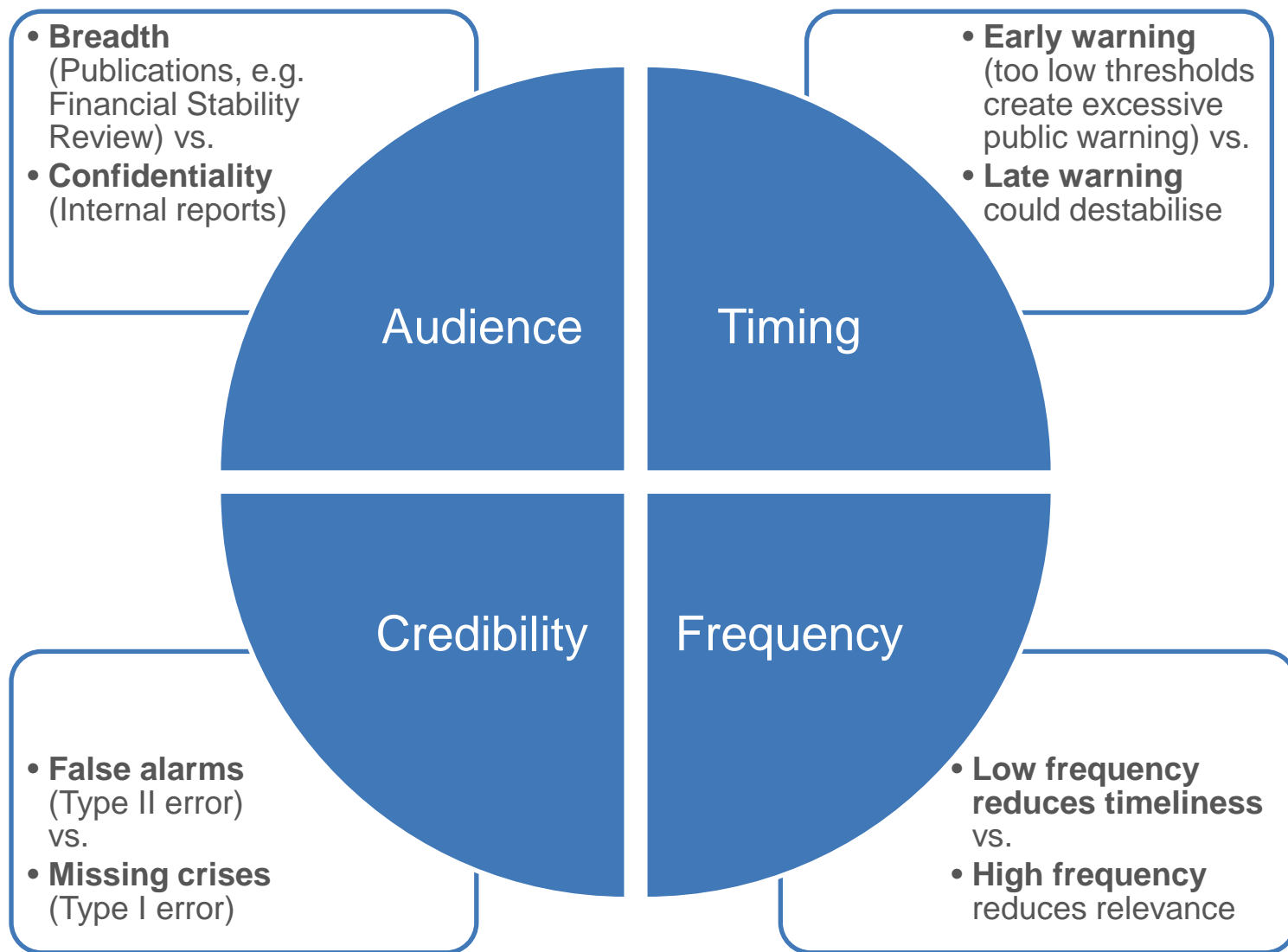
Assessment
 Tools need to take into account cross-sectoral and cross-border linkages and different propagation channels
 ↓
 Potential for under-/overestimating the severity of identified risks and the banking system's ability to absorb shocks

Policy response
 Risk of misguided policy conclusions
 ↓
 Need for policy action?
 Which type of instrument to use?
 Adequacy of calibration?

Effectiveness
 Risk mitigated and objective achieved?
 ↓
 Risk of policy action triggering further boundary and leakage effects
 ↓
 How to close loopholes?

Feedback to risk monitoring, identification and assessment

Communication trade-offs



Conceptual Issues

Financial stability communication

- i) Risk identification**
- ii) Resilience of the financial system
- iii) Macroprudential policies

Financial stability tasks and communication

- Communication on financial stability mainly concentrated around three main areas of responsibilities:
 - 1 Risk identification
 - 2 Resilience of the financial system (mainly via stress tests)
 - 3 Macro prudential policies
- **Transparent communication enhances effectiveness:** Reduce asymmetric information and educate the public about complex issues. Financial institutions, investors, firms and households behaviour may adopt their behaviour.

Process:

- Analysis of incoming data by sectoral experts
- Internal models (early warning, valuations, interconnectedness, financial cycles, profitability prospects and quantitative assessment of various macro-financial scenarios)
- Make use of in-house experts in other business areas (Economics, International, Market operations etc.)
- Market intelligence
- Judgement

Outcome: Identification and ranking of key risks that could unearth vulnerabilities in the financial system (see next slide)

Frequency: Risks updated each quarter








Communication channels: FSR (May and November), speeches, press releases

Challenges: Risks may be overlooked. Unintended behavior of markets/institutions. Media reports may not properly reflect the risks and vulnerabilities.

How are risks presented:

- Key risk table with ranking of key risks that could unearth vulnerabilities in the financial system.
- Succinct risk titles aimed at communicating:
 - i) the risks
 - ii) vulnerabilities and
 - iii) possible triggers
- Colors (levels) and arrows (changes)

Key risks to euro area financial stability

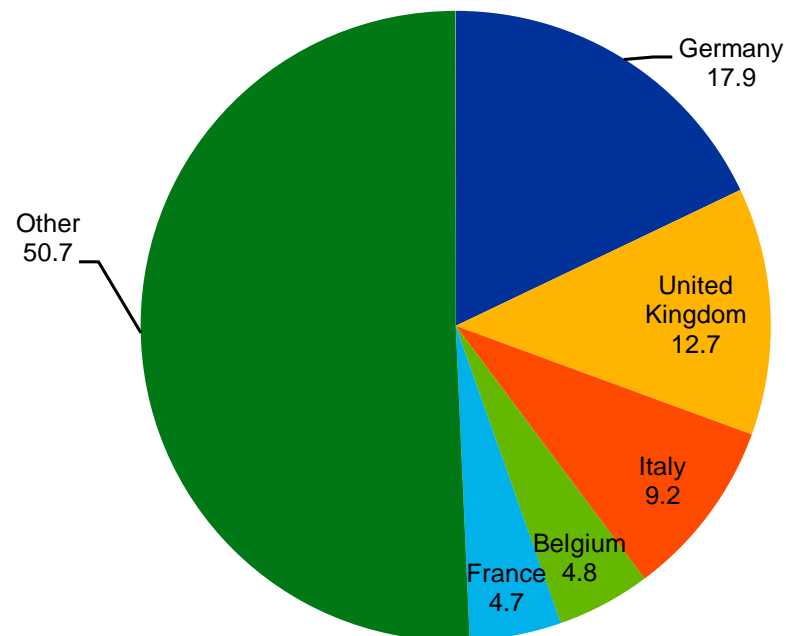
		Current level (colour) and recent change (arrow)*
	pronounced systemic risk	
	medium-level systemic risk	
	potential systemic risk	
	Global risk repricing leading to financial contagion, triggered by heightened political uncertainty in advanced economies and continued fragilities in emerging markets	
	Adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries	
	Re-emerging sovereign and non-financial private sector debt sustainability concerns in a low nominal growth environment, if political uncertainty leads to stalling reforms at the national and European levels	
	Prospective stress in the investment fund sector amplifying liquidity risks and spillovers to the broader financial system	

* The colour indicates the cumulated level of risk, which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next 24 months, based on the judgement of the ECB's staff. The arrows indicate whether the risk has increased since the previous FSR.

Number of downloads of the November 2016 FSR*

- Full PDF - **3121**
- Overview - **357**
- Chapter 1 - **189**
- Chapter 2 - **196**
- Chapter 3 - **299**
- Special Feature on leverage limits for alternative investment funds - **78**
- Special Feature on market failures in the resolution of NPLs in the euro area** - **867**
- Special Feature on banks' business models - **153**

Geographical breakdown of the Nov 2016 FSR



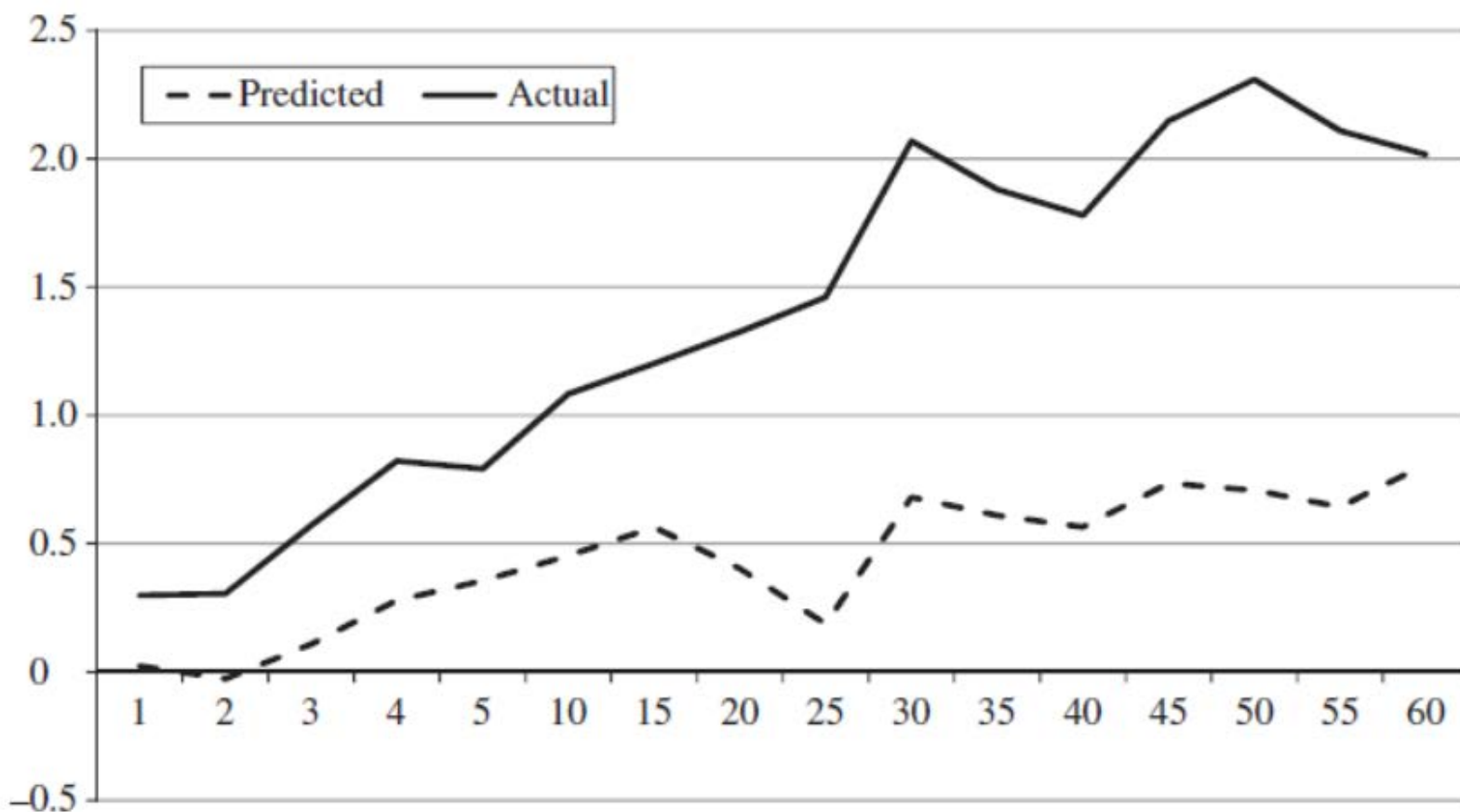
* Excludes downloads which may be facilitated through other external sites

** This Special Feature was published one day ahead of the publication of the FSR

Market reactions of Financial Stability Reports

Predicted Versus Actual Evolution of Stock Markets After FSRs

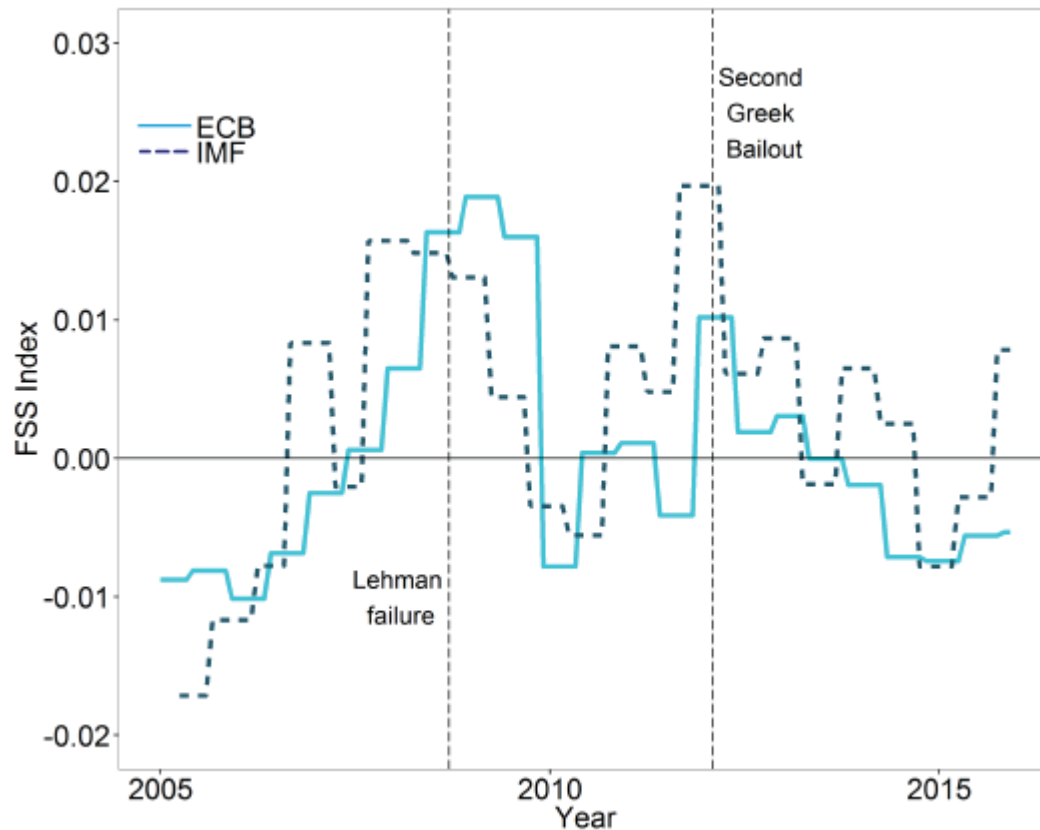
(y-axis: in percent, x-axis: days after publication)



Source: “Central Bank Communication on financial Stability” by Benjamin Born, Michael Ehrmann and Marcel Fratzscher, *The Economic Journal*, 124 (June), 701–734. 2013.

Notes: The study covers FSRs released in 35 countries over the years 1996 – 2009. The Figure compares the actual evolution of cumulated stock market returns (in %) following FSRs to the predicted evolution on the basis of a benchmark model. The solid line plots the average actual cumulated returns starting from day 1 after the communication event and up to day 60. The dashed line shows the expected cumulated returns that would result from the benchmark model in the absence of a communication event. The cumulated returns are multiplied by -1 for pessimistic communications, whereas they are left unchanged for optimistic communications.

ECB and IMF Financial Stability Sentiment (FSS) indices (2005 - 2015)



Index = (#negative words - #positive words) over # total words

Source: "Sentiment in central banks' financial stability reports" by Ricardo Correa, Keshav Garud, Juan M. Londonoy, and Nathan Mislang. International Finance Discussion Papers. March 2017
Notes: The graph shows the demeaned ECB and IMF FSS indices.

Conceptual Issues

Financial stability communication

i) Risk identification

ii) Resilience of the financial system

iii) Macroprudential policies

Assessing the resilience of the financial system

```
graph TD; A[Assessing the resilience of the financial system] --> B[Quantitative assessment of macro-financial scenarios that map the main systemic risks]; A --> C[Fully fledged stress tests];
```

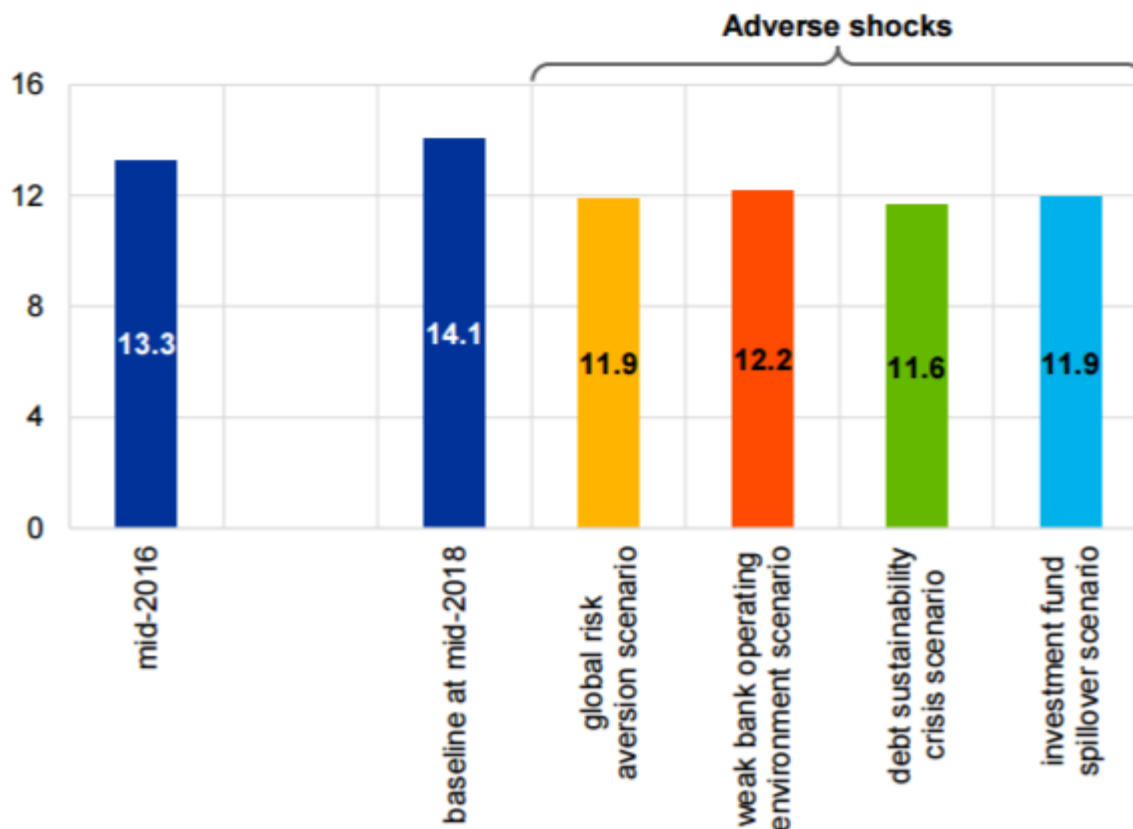
**Quantitative
assessment of macro-
financial scenarios that
map the main systemic
risks**

**Fully fledged stress
tests**

Quantitative assessment of four macro-financial scenarios that map the main systemic risks:

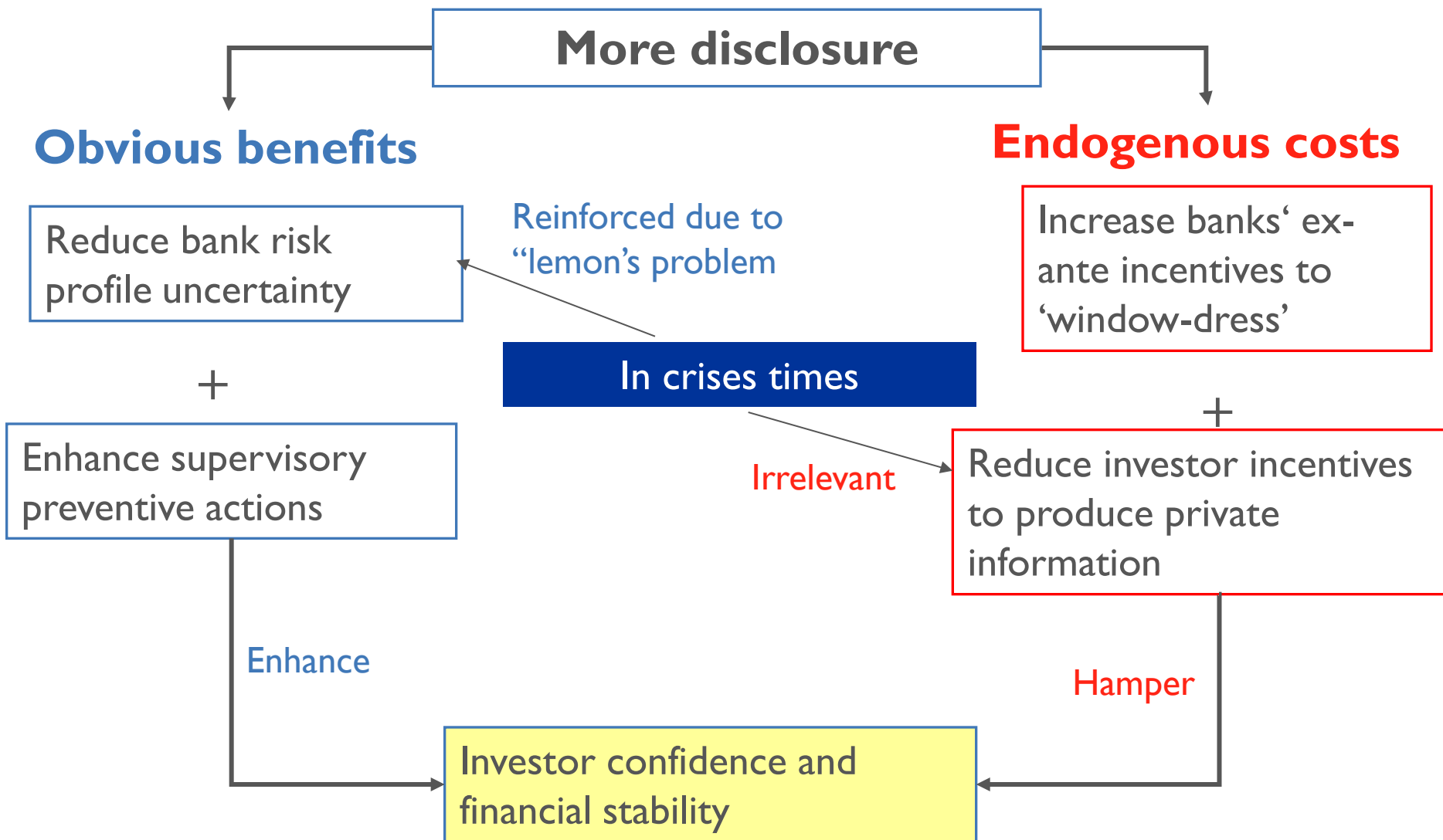
- Global risk aversion scenario
- Weak bank operating environment scenario
- Debt sustainability crisis scenario
- Investment fund spillover scenario

Average CET1 capital ratios of euro area banking groups under the baseline and adverse scenarios (Nov 2016 FSR) (2016-18, percentage, average of euro area banking groups)



Sources: Individual institutions' financial reports, EBA, ECB and ECB calculations.

Costs and benefits of conducting and communicating stress tests



Transparent Communication

- Press release
- Detailed report
- Bank-by-bank results
- Frequently Asked Questions

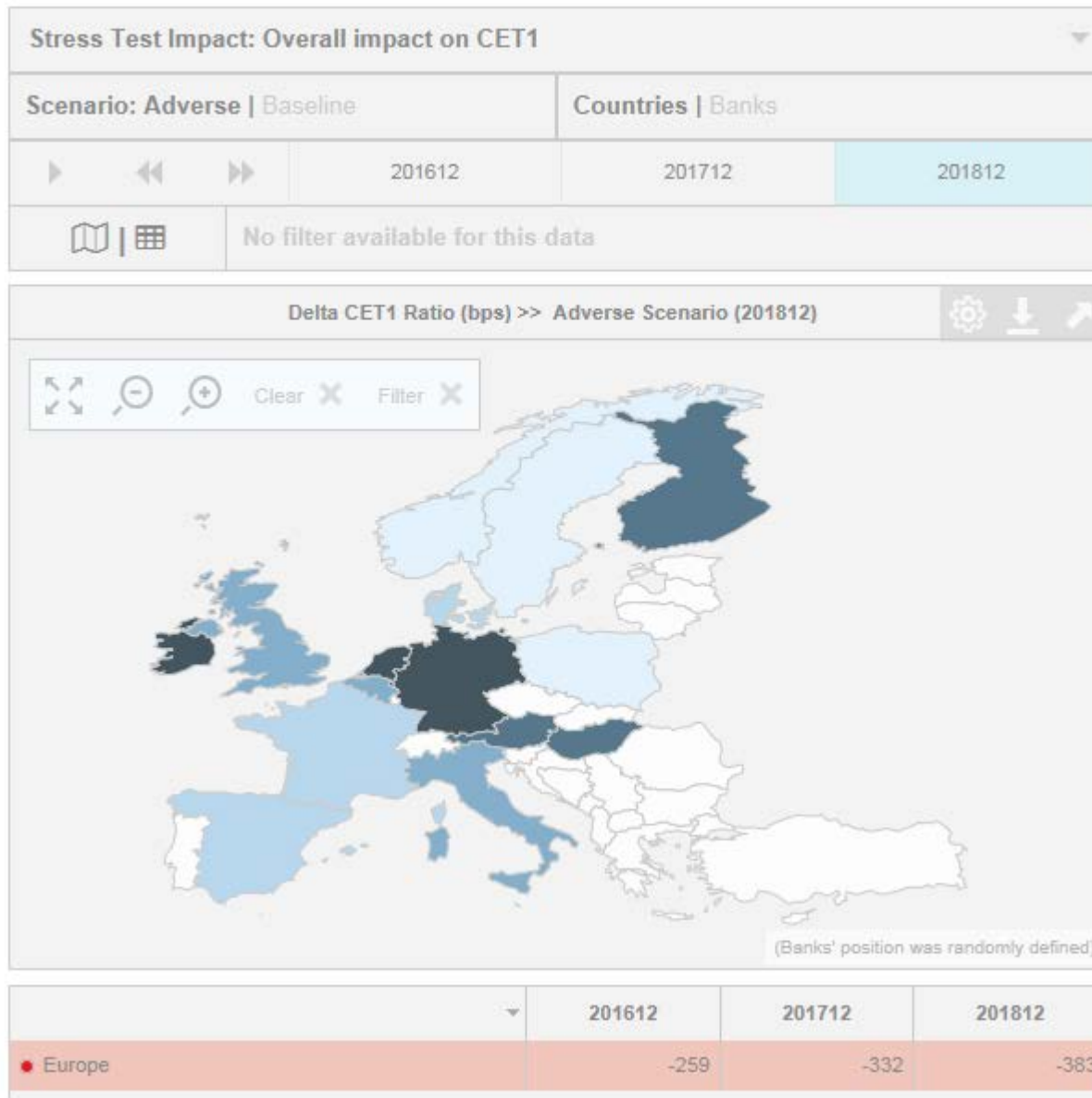
Tools:

Interactive maps – Overview by countries and by banks (see next slide)

Excel tools – country aggregation and bank specific figures. The excel files contain details about banks' credit risk, sovereign exposures, P&L, capital etc.

- <http://www.eba.europa.eu/risk-analysis-and-data/eu-wide-stress-testing/2014/results>
- <http://www.eba.europa.eu/-/eba-publishes-2016-eu-wide-stress-test-results>

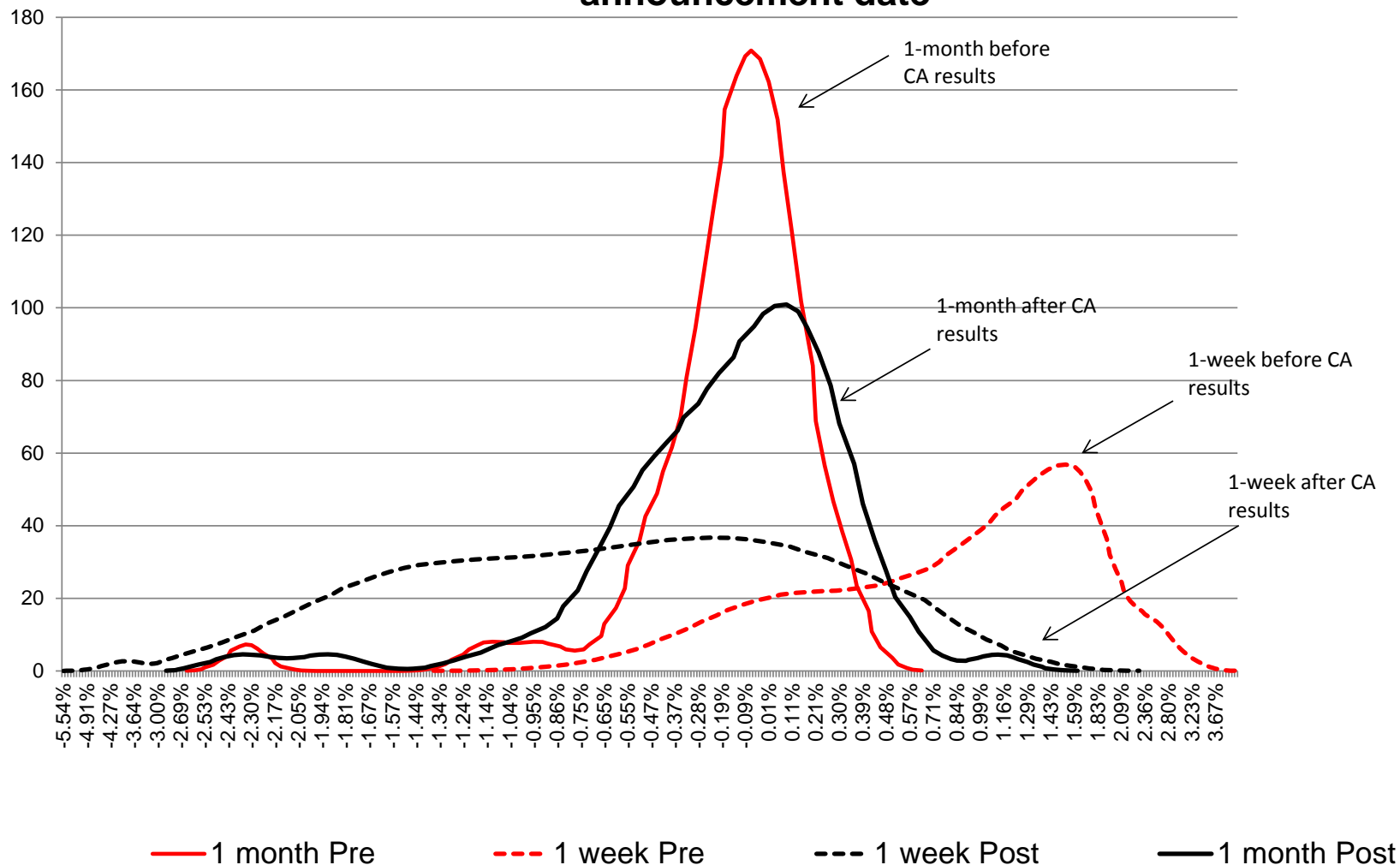
Stress test results - communication



Objectives achieved?

- **At least five desirable impacts from a macroprudential perspective:**
 - Convincing evidence of resilience or, if resilience is absent, triggering of measures to enhance resilience
 - Avoiding excessive deleveraging
 - Greater differentiation in the pricing of securities of participating banks (addressing adverse selection premia by revealing “lemons”)
 - Lowering of systemic risk
 - Reducing bank-sovereign nexus
- **Transparency policy has potential to influence all of these impacts**

Evolution and distribution of bank equity prices around the CA announcement date



Conceptual Issues

Financial stability communication

- i) Risk identification
- ii) Resilience of the financial system
- iii) Macroprudential policies**

Macprudential Policy Objectives

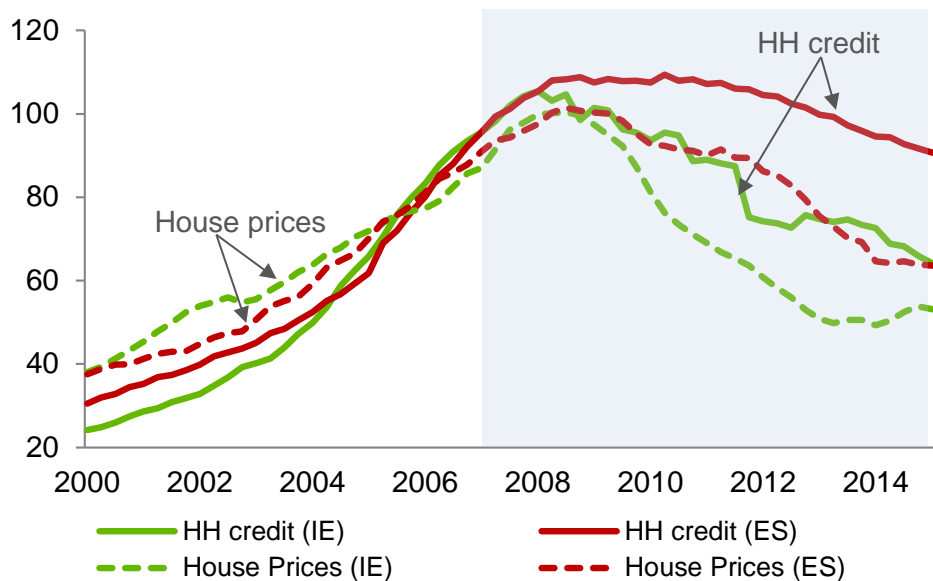
What can macroprudential policies (hopefully) achieve?

Curbing the financial cycle

Prevent excessive asset price and credit fluctuations to avoid boom-bust episodes

⇒ Need for instruments that are robust over the cycle

Credit and asset price cycle in Spain and Ireland (2007=100)



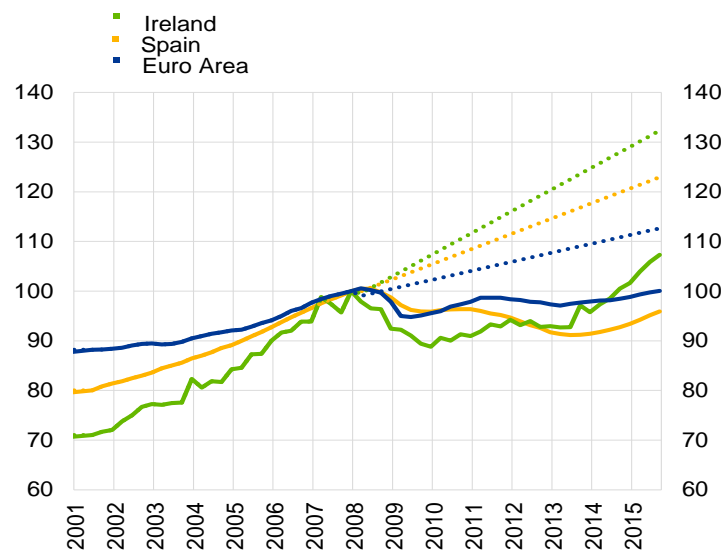
Source: ECB Residential Property Price Index Statistics for new and existing dwellings and ECB Balance Sheet Items Statistics for households and non-profit institutions serving households.

Prevent prolonged recessions

Avoid real economic costs and costly activation of public safety nets

⇒ Need for instruments that provide buffers to limit contagion or excessive spending adjustment

Euro area GDP more than 10% lower than 2001-2007 trend at end of 2015



Source: Eurostat, ECB calculations

Notes: All series are rebased to an index with 2007q4 as base quarter (=100). The dotted line is a linear extrapolation using the sample 2001-2007. Latest Observation: 2015q3

EU Oversight

Microprudential supervision

European System of Financial Supervision

European Banking Authority

European Insurance and Occupational Pensions Authority

European Securities and Markets Authority

National supervisors
(including supervisory colleges and SSM)

- Ensure EU-wide technical supervisory standards
- Coordination of supervisors

Macroprudential oversight

European Systemic Risk Board

ECB

National central banks

European Supervisory Authorities

European Commission

National Supervisors
(non-voting)

President of the Economic and Financial Committee
(non-voting)

- Issue risk warnings and macro-prudential recommendations

Macroprudential Oversight Process – role of the ECB

The ECB has the power to set higher requirements than those implemented by national authorities for the instruments covered by the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR).

	CRD IV Tools	CRR Tools	Other Tools
Capital based measures	<ul style="list-style-type: none"> • Countercyclical capital buffer (CCyB) • Systemic risk buffer (SRB) • G-SII & O-SII capital buffer 	<ul style="list-style-type: none"> • Risk weights for real estate sector and intra-financial sector exposures • Capital conserv. buffer • Own funds level 	<ul style="list-style-type: none"> • Leverage ratio
Liquidity-based measures		<ul style="list-style-type: none"> • Liquidity requirements • Large exposure limits (incl. intra-financial sector) 	<ul style="list-style-type: none"> • Non-stable funding levy • LTD ratio caps
Borrower-based measures			<ul style="list-style-type: none"> • LTV ratio caps • LTI ratio caps • DSTI ratio caps • DTI ratio caps
Other measures		<ul style="list-style-type: none"> • Large exposure limits (incl. intra-financial sector) 	<ul style="list-style-type: none"> • Margin and haircuts requirements
<p>Can be used by national authorities and the ECB (for SSM countries)</p>			<p>Can only be used by national authorities</p>

Warnings and recommendations (ESRB)

A **warning** is issued in order to raise awareness or draw attention to a systemic risk. Does not recommend specific remedial action in response to the risks identified.

Example Nov 2016: *“The ESRB issues eight Warnings on medium-term residential real estate vulnerabilities and a Recommendation on closing real estate data gaps”*

A **recommendation** is issued for remedial action when significant systemic risks are identified and when action is necessary to address these risks. Compliance via an *“act or explain”* mechanism.

Example: *“Recommendation of the European Systemic Risk Board of 22 December 2011 on US dollar denominated funding of credit institutions”*

ECB

15 December 2016 the ECB Governing Council issued a statement on Macroprudential Policies

- Cyclical systemic risks remain contained in most of the countries covered by ECB Banking Supervision and in the euro area as a whole, with the financial cycle slowly picking up.
- Real estate markets in some countries continue to recover from the financial crisis, whereas relatively buoyant real estate dynamics or high household debt levels in other countries signal the risk of increasing imbalances.
- Assessment regarding Global systemically important banks (G-SIBs) and other systemically important institutions (O-SIIs)
- The Governing Council conducted its assessment of all macroprudential decisions notified by national authorities to the ECB, in line with Article 5 of the SSM Regulation, and did not deem it necessary to apply higher requirements.

Link to the statement:

https://www.ecb.europa.eu/press/pr/date/2016/html/pr161215_1.en.html