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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

Market developments potentially requiring the use of Article 459 CRR

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This report is to inform the European Parliament and the Council on market developments potentially requiring the use of Article 459 of the Capital Requirements Regulation (CRR)[1] in the past year. It is based on an assessment provided by the European Systemic Risk Board (ESRB)[2].

1. BACKGROUND

Article 459 CRR provides that the Commission, assisted by the ESRB, has to submit a report, at least on an annual basis, to the European Parliament and the Council on market developments potentially requiring the use of this Article. Pursuant to Article 459 CRR, the Commission may impose, for a period of one year, stricter requirements concerning the level of banks' own funds, large exposures, or public disclosure, under specific conditions, in particular upon the recommendation or the opinion of the ESRB or EBA. The required conditions are that these measures are necessary to address changes in the intensity of micro-prudential and macro-prudential risks which arise from market developments in the Union or outside the Union affecting all Member States, and that the instruments of the CRR/CRDIV are not sufficient to address these risks.

2. CONCLUSION AND WAY FORWARD

The European Commission has not yet seen any circumstances that would warrant the use of Article 459 CRR, considering in particular that this Article allows only for tightening measures, the priority of the other CRR/CRDIV instruments and the fact that measures under Article 459 CRR may only be imposed where the respective market developments affect all Member States. In accordance with this assessment, neither the ESRB nor the EBA have recommended to the Commission to take action under Article 459 CRR at this stage.

The Commission will continue to monitor in close cooperation with the ESRB relevant market developments in the Union or outside the Union potentially requiring the use of this Article.

3. ANALYSIS

3.1. General overview

The Commission considers the situation of the EU financial system in the past year to be considerably different from circumstances warranting measures under Article 459 CRR. More specifically, there is no credit-driven overheating of the economy. Leverage in the economy, whilst high by both historical and international standards, is not

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[2] The assessment provided by the ESRB on 2 May 2016 is available at https://www.esrb.europa.eu/pub/pdf/other/20160502_letter_md.en.pdf?90e22809ce71729e2d5902d9aa7dbf46. In addition, this report also builds on the European Commission's economic forecast and analysis by the European Central Bank, the European Supervisory Authorities, the European Banking Authority and the International Monetary Fund.

increasing, nor is there evidence of increasing leverage in the banking sector. This trend can be expected to continue.

The EU economy is on a subdued growth path, which means that the risk of overheating in the economy is limited. According to the latest Commission forecast, real GDP growth will be below 2% in 2016 and 2017 in the EU and euro area. The output gap will remain negative and consumer price inflation is forecast to stay below the 2% threshold that the ECB considers consistent with price stability. Consistent with low rates of inflation and the subdued growth environment, central bank rates have reached very low levels. This, together with asset purchases by central banks, has translated into low interest rates on bond and credit markets. Despite low interest rates, debt of non-financial corporations and households, relative to GDP, is not increasing in most EU Member States, and a downward trend is expected to set in once economic growth picks up. In the current subdued growth environment demand for credit should not boost excess leverage in the financial sector. External developments are unlikely to lead to overheating pressure in the EU economy in the near term as both world GDP and world trade are forecast to grow substantial below long-term trends. The outcome of the UK Referendum about the country's membership in the EU significantly increased uncertainty (as measured by the Baker-Bloom index) has added downside risks to the growth prospects of the EU economy and may curtail many actors' desire to become more indebted. The banking sector, which forms the backbone of the EU financial system, is not increasing leverage. Banks' regulatory capital ratios picked up during 2015 and remained at about the same level during 2016 according to preliminary EBA data. This holds for both Core Equity Tier (CET) 1 ratios and total capital ratios. The weighted average EU CET1 ratio stood at 13.5% in mid-2016, and less than 5% of banks had a ratio of below 11%. ECB statistics suggest that the total balance sheet size of monetary financial institutions (MFIs) excluding the European System of Central Banks (ESCB) barely increased during 2015 and 2016. For comparison, in the pre-crisis period 2001-2008 MFI total asset growth was about 10% p.a. Banks' lending has also been subdued in the EU. For example bank lending to the private sector in the euro area has grown by less than nominal GDP in 2015 and 2016. The ESRB measure of the credit GDP gap is negative and may have just bottomed out in 2016. High levels of non-performing loans (NPLs) act as a break on credit growth. They imply costs for banks in managing loans, thereby reducing incentives to expand credit supply. They are also an indication of debt overhang in the corporate and household sectors. Corporations or households with bad debt may think twice before investing, knowing that banks will charge a higher credit cost to compensate for the risk

According to the results of the 2016 EBA stress test, the aggregate EU banking sector is satisfactorily resilient to shocks. In the adverse scenario, which combines a severe recession with large shocks to a wide set of financial asset prices, the average CET1 ratio would fall to 9.4%. This is higher than the comparable 8.5% outcome of the 2014 stress test and means that the EU banking sector has continued to build up considerable buffers to use in case of adverse economic developments. What is more, the stress test revealed considerable heterogeneity of banks' exposure to adverse shocks across institutions. Hence, changes of risks in this area could be more appropriately addressed by national measures under CRR/CRDIV than by broad-brush measures under Article 459 CRR.

3.2. EU financial stability risks identified by the ESRB

Over the past year, the ESRB has identified four overarching risks for the European economy. These risks are the re-pricing of risk premia in global financial markets, amplified by low market liquidity, further weakening of banks' and insurers' balance sheets, deterioration of debt sustainability in sovereign, corporate and household sectors, and shocks and contagion from the shadow banking sectors. The potential relevance of these risks for measures under Article 459 CRR is assessed in more detail below.

(a) Re-pricing of risk premia

The possible re-pricing of risk premia in global financial markets, amplified by low liquidity, is being considered as a major macrofinancial risk in the European financial sector.

This risk is inter alia motivated by high prices in a number of asset classes relative to historical averages. High asset prices are to a significant extent driven by a low interest rate level, which spurs a search for yield among many investor classes. Although there are signs of high risk-taking in some corporate bond markets and real estate markets, they are heterogeneous across market segments and Member States. This is particularly valid for signs of overheating that are present in real estate markets in some Member States, but virtually absent in others.

Capital positions of financial institutions subject to CRDIV/CRR should be sufficiently high to weather a materialisation of this risk. In the EBA stress test, market risk in the adverse scenario curtailed the CET 1 ratio by just 1 percentage point, out of a total drop by 3.8 percentage points in the adverse scenario. Hence, market risk was not the main contributor to the capital erosion identified in the stress test. Of course, the market risk can materialise in a different form than assumed in the stress test. It is, however, reassuring that over recent years the financial sector has shown sufficient resilience during episodes of sharp adjustments of risk premia on global markets. Such events were the flash rally in US Treasuries in October 2014, the sell-off in the German Bund in May/June 2015, the exchange and share price adjustment after the UK Referendum in June 2016 and the sudden increase in Japanese yields in August 2016. These left a short-lived trail in other financial asset prices and did not cause havoc in any financial institution. A further notable market development relates to occasional sharp reactions of EU banks' share prices[3]. While one may regret that exposures to market risk are difficult to monitor, policy proposals in this area are under way with the fundamental review of the trading book initiated in the Basel framework and are expected to be more effective than any measure towards more transparency under Article 459 CRR.

(b) Further weakening of banks' and insurers' balance sheets

A further weakening of banks' and insurers' balance sheets is another overarching risk for EU financial stability identified by the ESRB. The trend decline in EU banks' share prices during most of 2016 underpins the relevance of this risk since it indicates a substantial loss in banks' market values. Downward share price developments

[3] Since share price developments are closely linked to the risk of a further weakening of banks' and insurers' balance sheets they are assessed in the next section.

accelerated notably when markets priced in news about economic risks, reiterating the close connection between the first two items on the ESRB list of systemic risks. More detailed inspection, however, suggests that the pronounced decline in banks' share prices was not primarily driven by scepticism about banks becoming insolvent, but rather about their profitability outlook. If markets had been concerned about banks' solvency, CDS prices and yields of banks' debt instruments should have also gone up strongly, but this could not be observed apart for some institute-specific financial instruments.

Particularly noteworthy episodes in 2016 that inform about the profit outlook for banks were (i) weak economic data releases in February 2016 (ii) the outcome of the UK Referendum in June 2016, and (iii) the EBA stress test results in August 2016. During these three episodes, most banks' share prices severely underperformed share price developments of non-banks and in all three episodes market analysts pointed to determinants of profitability. In February 2016, the weak data releases intensified the notion that interest rates will remain low for long, which would entrench low profit margins and small revenues from maturity transformation. The outcome of the UK Referendum questions whether London will continue to fulfil its role as financial hub for the EU efficiently. Exit of the UK from the EU may entail higher costs in cross-border wholesale funding. The EBA stress test revealed the sensitivity of banks to an adverse economic scenario.

Although a higher capital ratio of the EU banking system at large and of the most vulnerable banks specifically may have contained the valuation losses in these episodes, a request to banks by public authorities to accomplish higher capital ratios is likely to have had detrimental effects. The reason is that the low profitability of many banks has already reduced the scope to increase capital substantially at short-term notice. First, low profitability reduces the amount available to increase capital from retained profits. Second, if banks raise capital ratios by accelerating the ongoing reduction in activity or risk taking, profitability is likely to dampen further and there is a risk that credit constraints to the economy could emerge. Third, the low equity valuations unveil the high costs of equity banks face in issuing capital via equity issuance. Based on an EBA survey, the IMF estimates that the average cost of equity in the EU banking system is around 9%. Returns on equity are around 6% on average according to EBA data and around 2% for medium-sized banks. As costs of equity outstrip the returns on equity for many banks, requests to increase capital ratios would weaken profitability further. Consistent with this theoretical argument is what some market analysts (from investment banks and credit rating agencies) reported about the likely trigger for the share price losses in February 2016. They considered rumours that supervisors imposed possible restrictions on dividend payments to shareholders on some banks in order to strengthen their capital position a relevant trigger. Hence, the investor base for equity investments in banks has been sensitive to policy-induced measures that curtail the profitability of their investment. This experience suggests that the policy instruments proposed by Article 459 CRR are unlikely effective in periods of subdued growth and downbeat expectations about banks' profit outlook. As said above, measures under Article 459 CRR are likely most effective in times of excess optimism in banks profitability and in share price valuations.

Low profitability in EU banks is driven by cyclical, legacy and structural factors. Subdued nominal economic growth and low central bank interest rates have been major cyclical factors. Nominal economic growth has constrained the financial sectors'

potential to expand service provision to the economy. Demand for bank lending has been equally subdued. Low interest rates and a flat yield curve imply low margins for financial intermediaries, most evident in lower profits from maturity transformation. Moreover, the zero-lower bound of interest rates impacts banks' profitability since banks are not able to charge negative interest rates to retail depositors as these have the alternative of holding cash instead of deposits. Legacy factors relate first of all to high burden of non-performing loans (NPL) in some parts of the banking system, especially in those Member States where prolonged low economic growth led to high levels of NPLs. Banks have different option to address NPLs, but often the incentives doing so are not sufficient. For example, realising losses from NPLs or selling them at a discount, unless already provisioned, would trim profits and capital ratios. The alternative of maintaining them on the balance sheet (evergreening) provides temporary relief, but comes at the expense of more uncertain asset quality, which may result in higher costs on funding markets and in reluctance to expand lending to the economy. Also, high NPLs imply high cost of managing bad loans.

Low profitability in the banking sector if entrenched may lead to solvency issues in the medium term. Although macro-prudential policy may play a role in addressing the cyclical factors behind low profitability by loosening existing constraints on bank activity, Article 459 CRR is not a suitable means in this respect. It only allows stricter prudential requirements for a period of one year and not a loosening. Article 459 CRR has also limited impact on NPLs. The legacy problem of high NPLs would best be tackled by more efficient insolvency procedures that allow banks to resolve NPLs more quickly. As proposed by the Commission, the Council addressed NPLs in Country Specific Recommendations to six Member States in July 2016. The Commission is in close communication with national authorities as well as European stakeholders to ensure adequate action. Prudential requirements under Article 459 CRR might be able to foster structural change since financial institutions struggling to meet them would be prompted to shrink balance sheets, reduce business or even exit the market. Given the temporary nature of measures under Article CRR 459, i.e. active for a period of one year, however they are not suitable means to foster any desirable structural change in the EU banking system.

(c) Deterioration of debt sustainability in sovereign, corporate and household sectors

The deterioration of debt sustainability in sovereign, corporate and household sectors, even if applying rather uniformly and significantly to all Member States, would not be effectively addressed by measures under Article 459 CRR.

The impact of measures that reduce leverage in the banking sector on debt sustainability of non-financial actors is ambiguous. While it is possible that they lead to deleveraging in the non-financial economy that spills over to improved debt sustainability, it may also result in impaired access to credit that provokes the existing debt positions to become unsustainable.

(d) Shocks and contagion from the shadow banking sectors

As regards risks posed by the shadow banking sector, the approach taken under the large exposures regime of the CRR seems sufficient at this stage and there is no need for recourse to Article 459 CRR. EBA Guidelines on limits on exposures to shadow

banking entities were adopted in December 2015 and apply from 1 January 2017[4]. They provide general principles institutions should comply with in order to address risks that exposures to shadow banking entities may pose them, a principle approach for setting limits to exposures to shadow banking entities and a fallback approach in case institutions are not able to apply the principal approach. The work done by the EBA will feed into the Commission report under Article 395(2) CRR on the appropriateness and impact of imposing such limits, which will also take into account international developments on risks arising from shadow banking entities.

[4] https://www.eba.europa.eu/documents/10180/1310259/EBA-GL-2015-20+GL+on+Limits+to+Exposures+to+Shadow+Banking+Entities.pdf/f7e7ce6b-7075-44b5-9547-5534c8c39a37.