Key takeaways from the ECB’s new Financial Stability Review

SUERF-BAFFI Bocconi E-lecture 1 June 2023

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Key takeaway from the ECB's May 2023 Financial Stability Review

Main risks and vulnerabilities

- There are already signs of deteriorating asset quality in loan portfolios exposed to commercial real estate, smaller firms and consumer loans.
- Euro area real estate markets are undergoing a correction, which could turn disorderly.
- Higher funding costs may weigh on future profitability of euro area banks.
- The potential for disorderly asset price adjustments has risen due to high valuations and low market liquidity.
- Higher interest rates and geopolitical tensions, but also climate risk put pressure on sovereigns.

Key policy messages

- Targeted macroprudential policy action is needed and existing macroprudential capital buffers should be maintained.
- It is essential to complete the banking union and establish a common European deposit insurance scheme as that will reinforce the ability of the euro area financial system to withstand risks going forward.
- Structural vulnerabilities in non-banks such as liquidity mismatches in funds should be addressed.

First impressions by a resolution and deposit insurance authority

- We welcome the impressive work done by the ECB and euro area central banks in identifying risks to financial stability, making different stakeholders aware of them and pushing authorities to implement mitigating measures.
- We acknowledge that there might still be bank failures and thus we as a resolution and deposit insurance authority need to be ready to deal with such a situation and prevent it from snowballing into a large-scale financial crisis.
- We need to be ready for any kind of crisis, as highlighted by the very broad range of risks described in the FSR.
- We should assess what tools might be best suitable for the different situations described in the FSR and how the tools should be further developed to be fit for purpose.
  - We need to be ready for very rapidly escalating liquidity crisis in a situation where the risk sentiment is fragile, and stakeholders are highly sensitive to surprises.
  - But we cannot forget the causes of previous crisis either as the interest rate environment might well result in realisation of credit risks, even though with a delay.
- We are interested in individual observations in the tails on the distribution of banks, and hence need to go behind the aggregate level assessments in close dialogue with both banks and supervisors.

Aspects to remember from special feature A on market and funding liquidity

- We need to remember the different dimensions of liquidity and their interrelation when assessing banks' funding plans and ability to issue MREL eligible resources to meet the final targets by January 2024, and on an ongoing basis from then on.
- We need to highlight when discussing MREL targets that these push banks towards a more stable funding mix given the longer maturity of eligible resources in comparison deposits, which might not be as sticky as we have thought, and short-term wholesale funding.
- We need to capitalise on the analysis of banks' role as market makers when assessing the criticality of trading functions feeding into the public interest assessment.
- We need to remember the persistent trend towards secured funding and that the lower level of unencumbered assets also makes it difficult to mobilise collateral for liquidity at the time of resolution.
- We need to account for very challenging liquidity situation at the time of failure, highlighting the need for pre-planned arrangements, in addition to a fully ratified SRF backstop, to ensure financial continuity of the resolved bank, as access to market funding might be lacking for quite some time.
- We note the decline in deposit growth rates and follow the implications of this on the banking sector in terms of changes in the size of contributions to resolution and deposit insurance funds.

What a resolution and deposit insurance authority would like to know more about

- How could we quantify the deposit run risk in different customer groups to support the criticality assessment of the deposit function and assess the likelihood of failure? To what extent will lack of engagement in the green transition trigger deposit outflows by households, corporates or NBFIs, or impact market funding in the future?
- To what extent is the work of banks to become resolvable by January 2024 visible in the financial performance and funding costs, but also in the assessment of financial stability risks?
- What does the European M&A market in the banking sector really look like, and what do we need to do to ensure a sufficient long list of possible buyers to facilitate the implementation of the sale of business tool in resolution?
- What implications would the suggested changes to the crisis management and deposit insurance framework have?
  - How will the change in credit hierarchy affect funding costs and appetite for senior unsecure debt?
  - How will the lower threshold in the public interest assessment affect funding costs, and in particularly the implicit government guarantee, if there is any?
  - How do we quantify real economy implications of failure on a regional level and to what extent does this help us in assessing the possibility that liquidation aid might be used in case of bankruptcy?

RVV hopes for the institutional set-up

Resolution and deposit insurance under the same roof, as in RVV

- Ensures that tools to be applied as bank fail can be seen as a continuum and handled consistently by the same authority.
- Ensures seamless cooperation for example in assessing financial stability implications of different measures and of the use of funds as well as in assessing legislative proposals.
- Ensures efficient use of data.

Finalising the banking union with EDIS

- Ensures that depositors in every member state is in the same position.
- Ensures that the capacity of the fund is sufficient.
- Ensures that the bank sovereign nexus is loosen rather than tightened.

… and combining it with SRF

- Further improves the credibility of the fund.
- Removes overlaps, conflicts of interest and facilitate decision making.

Kiitos.
Tack.
Thank you.