Press release

18 December 2020

The General Board of the European Systemic Risk Board held its 40th regular meeting on 15 December 2020

At its meeting on 15 December 2020 the General Board of the European Systemic Risk Board (ESRB) continued to discuss the impact of the coronavirus (COVID-19) pandemic on the European Union (EU) economy and the financial system. Despite a strong rebound of economic activity in the third quarter of 2020, the second wave of COVID-19 infections in the EU and the concomitant increase in the stringency of containment measures render the economic recovery path highly uncertain. However, the prospect of COVID-19 vaccines becoming available has reduced the probability of more severe scenarios. Against this background, the General Board continued to consider that the main source of systemic risk in the EU originates from the negative impact of the pandemic on economic activity that may give rise to widespread defaults in the private sector and their feedback effects on the financial system. The General Board noted that broad-based policy support measures have been essential to mitigate the impact of the crisis on households and firms as well as to contain a spillover from the non-financial private sector to the banking system. However, the longer the COVID-19 crisis lasts and the more severe its impact is on countries and economic sectors, the more pronounced the deterioration in asset quality will be. Banks, therefore, need to be proactive by identifying and provisioning for non-performing loans. Recognising losses at an early stage will be key to keeping banks' balance sheets transparent and avoiding cliff effects, thereby contributing to the recovery by sustaining credit to the non-financial private sector. In this vein, the General Board welcomed the European Commission's initiatives and emphasised that tackling non-performing loans should be high on the agenda of all authorities. The General Board also noted that containing the risks mentioned above may require an extension of the comprehensive policy measures until the economic recovery is firmly entrenched.

In this context, the General Board discussed the financial stability implications of fiscal measures to protect the real economy from the COVID-19 pandemic. ESRB analysis[1] confirmed the significance of the fiscal support measures for lending, with up to 35% of new bank lending being subject to those measures. However, in some instances the evidence pointed to a limited uptake of fiscal measures. This might reflect

[1] Based on the EU-wide monitoring framework established by the General Board with data obtained under ESRB Recommendation 2020/8. This analysis will be published in early 2021.

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administrative bottlenecks or reluctance to enter higher indebtedness. The General Board also discussed the heterogeneity of support programmes across different countries. This heterogeneity can and should reflect country-specific vulnerabilities, differences in the impact of the crisis from country to country, and differences in national financial systems. For example, countries hit harder by the pandemic tend to have larger programmes with a larger uptake; countries with a higher share of employment in vulnerable sectors rely more on direct grants; and the uptake of moratoria is positively correlated with pre-crisis debt levels of non-financial corporations and households. However, the observed heterogeneity also reflects differences in fiscal space and a potential lack of policy coordination. Going forward, this could hamper an efficient use of cross-border financial flows and risk sharing, with potentially negative effects on financial stability. Considering main risks to financial stability described above, the General Board discussed priority issues related to national support measures. Among these priorities the General Board highlighted (i) avoiding cliff effects while phasing out measures, (ii) targeting fiscal measures at solvency support to viable firms, (iii) monitoring private debt sustainability, (iv) preparing for a scenario with increased distress in the corporate sector, and (v) enhancing financial institutions' balance sheet transparency. Furthermore, the General Board underlined the need to coordinate policies across policy areas and countries. For example, addressing potential solvency issues will require policy responses that are coordinated across many policy areas, including insolvency legislation, labour and social policies, and competition policy.

To this end, the General Board also considered a note prepared by the Advisory Scientific Committee (ASC) – an upcoming ASC Insight on corporate insolvencies in the context of the COVID-19 pandemic. The ASC Insight highlighted a need to overcome several deficiencies in insolvency frameworks to facilitate an efficient process of restructuring and reallocation of productive assets. Furthermore, it stressed that formal insolvency procedures were often not well suited to dealing with small and medium-size enterprises in particular with respect to the exploration of restructuring options. Finally, the ASC Insight made a case for increasing the capacity and efficiency of the judiciary to prevent congestion on account of a potentially surging number of insolvency procedures. The ASC Insight will be published in early 2021.

While the General Board acknowledged the reduced uncertainty in macroeconomic projections and the fact that the European financial system has proved its resilience, it also noted that the recovery path of the economy is still facing important challenges going forward. Against this background and bearing in mind the fact that the resilient financial system is key to providing vital services to the real economy, the General Board decided to revise and extend its Recommendation on restriction of distributions. The General Board recommended that relevant authorities request banks, investment firms, insurance companies and reinsurance companies to refrain from distributions[2] which have the effect of reducing the quantity or quality of own funds[3], unless these financial institutions apply extreme caution in carrying out distributions and the resulting reduction does not exceed the conservative threshold set by their competent authority. The revised Recommendation is in line with the decisions taken in parallel by the European Banking Authority, European Insurance and Occupational

[2] This means any of the following: making a dividend distribution or giving an irrevocable commitment to make a dividend distribution; performing buy-backs of ordinary shares; or creating an obligation to pay variable remuneration to a material risk taker.

[3] At the EU group level and, where appropriate, at the sub-consolidated or individual level.

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Pensions Authority and ECB Banking Supervision and aims to ensure that financial institutions maintain a sufficiently high level of capital to mitigate systemic risk and contribute to economic recovery in case of further economic disruptions.

At the same time, the General Board recognised that, as mentioned above, the prospect of COVID-19 vaccines becoming available has reduced the probability of more severe scenarios. The General Board also recognised the importance of distributions in enabling financial institutions to raise capital externally.

Therefore, the General Board called for extreme caution regarding distributions so that they do not put the stability of the financial system and the recovery process at risk. To this end the General Board recommended that the competent authorities set a conservative threshold, which should be calibrated paying due regard to:

a) the need for financial institutions to maintain a sufficiently high level of capital, also taking into account the risks of a deterioration in the solvency position of corporations and households in view of the pandemic;
b) the need to ensure that the overall level of distributions of financial institutions under their supervisory remit is significantly lower than in the recent years prior to the COVID-19 crisis;
c) the specificities of each sector within their remit.

Previously the General Board also included central counterparties (CCPs) within the scope of its Recommendation. However, the stress test exercise regarding CCPs in the EU conducted by the European Securities and Markets Authority confirmed the overall operational resilience of EU CCPs to common shocks and multiple defaults for credit, liquidity and concentration stress risks.[4] Considering the effectiveness of the measures deployed by CCPs to mitigate operational risk, the General Board decided that it is no longer necessary to include CCPs within the scope of the Recommendation.

Finally, the General Board decided that the Recommendation will apply until 30 September 2021. At the same time, the General Board noted that the measures covered under the ESRB Recommendation are of a temporary nature and the ESRB will continue to monitor their implications for financial institutions and their ability to contribute to economic recovery. The General Board noted that it will decide if and when this Recommendation needs to be amended, taking into account, inter alia, macroeconomic developments as well as new data about the stability of the financial system.

The General Board also approved the adverse scenario for the European Banking Authority's 2021 EU-wide stress test. The adverse scenario will be published at the end of January 2021, when the EU-wide stress test is to be launched.

The ESRB is releasing the 34th issue of its risk dashboard **today**. The risk dashboard is a set of quantitative and qualitative indicators of systemic risk in the EU financial system.

[4] See ESMA's Third EU-Wide CCP Stress Test Finds System Resilient to Shocks.

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