

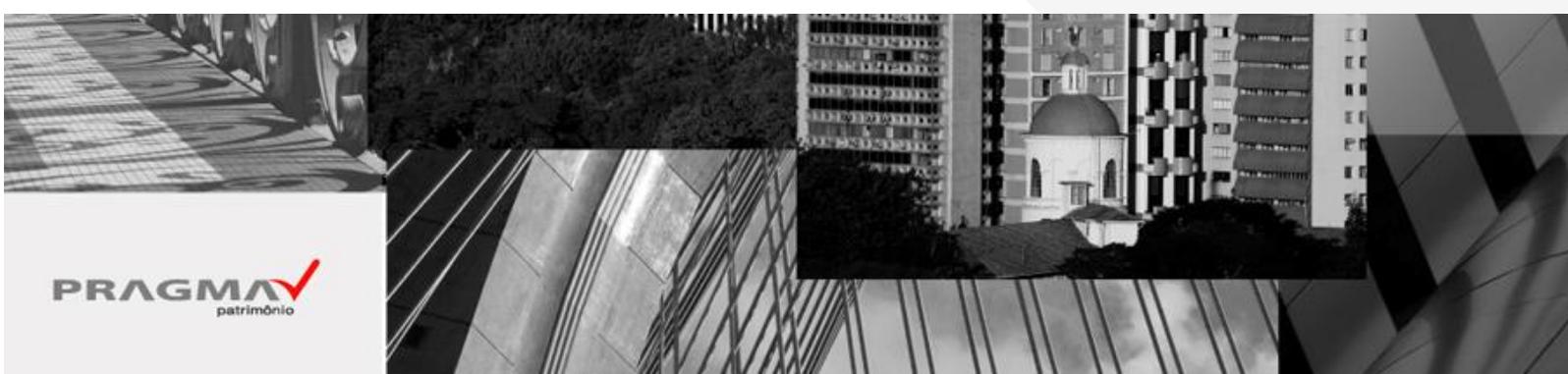
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Randal K. Quarles: Stress Testing: A Decade of Continuity and Change ..... 1

Luis de Guindos: Macroprudential policy ten years after the crisis ..... 7



## **Randal K. Quarles: Stress Testing: A Decade of Continuity and Change**

*Remarks by Randal K. Quarles, Vice Chair for Supervision, Board of Governors of the Federal Reserve System at “Stress Testing: A Discussion and Review”, a research conference sponsored by the Federal Reserve Bank of Boston, July 9, 2019.*

\* \* \*

Thank you Eric, and thank you to everyone at the Boston Fed and throughout the system who have contributed to this conference. This gathering comes a few weeks after the announcement of this year’s stress test results, so let me begin by recounting the highlights of those results. They show that our financial system remains resilient and that capital planning by banks continues to improve. The largest and most complex banks were tested against a severe hypothetical recession and retained strong capital levels, well above their minimum requirements. They demonstrated the ability to withstand a severe and lasting economic downturn and still be able to lend to households and businesses. Additionally, most firms are now meeting the high expectations we have set to make sure capital planning takes into account their specific risks and vulnerabilities. This is an improvement from last year. Overall, these results are good news that confirm our financial system is significantly stronger than before the crisis.

Now let me turn to the purpose of this conference, which is to sharpen our understanding of the experience gained from stress testing and apply these lessons to think about the future. And let me begin by acknowledging that—notwithstanding our openness to learning from the collective experience of all of us in this room—the future of stress testing will, in a number of important ways, necessarily resemble the past. For example, we’re still going to have them. Over the course of the last 18 months, I have heard overwhelmingly—from academics, from think tanks of every stripe, from banks of every size, from regulatory colleagues both domestic and foreign—that stress tests should continue to be a key element of the Federal Reserve’s supervision of systemically important banks and a key aspect of the Fed’s efforts to promote financial stability. Stress tests should be regular, rigorous, and dynamic. And the banks’ performance on these tests will continue to be the most risk sensitive and consequential assessment of the affected banks’ capital requirements.

Transparency around the stress testing process and results was a fundamental principle of the first stress test and every one that has followed, and it will remain a primary goal. Stress tests, as ever, will provide the public with essential information to assess the health of banks and the overall financial system. To be credible, stress tests will also continue to provide significant information about how the Fed does its work, so the public can understand the rigor and independence of our assessment process and how we come to our judgment of the firms we test.

Fidelity to these principles, embraced in the depths of the crisis by the first stress test a decade ago, does not mean that stress testing should never change or that it hasn’t changed over the years. We have learned from our experiences with the early tests and added useful features and adjustments. These include a counterparty default scenario, as well as a

number of policy statements that more explicitly convey the principles we find important in a sensible stress testing program.

Stress testing has evolved, and must continue to evolve, to take on what we as supervisors learn from our work and what we can learn from others. Each year, we have refined both the substance and the process of the stress tests, guided by our own experience and by critiques and suggestions from others. This feedback comes from a variety sources, including conferences such as this one, and I am confident that the presentations today will provide insights that result in improvements in our stress tests.

If stress tests are to continue to be relevant and effective, I strongly believe that they must continue to change: they must respond to changes in the economy, the financial system, and the risk-management capabilities of firms. Evolutionary change has been a consistent principle of stress testing since the beginning, embraced by my predecessors at the Board of Governors and our supervisory staff and reflected in each cycle of tests. Without such adjustments, regulators, banks, and the broader public cannot get a clear and dynamic view of the capital positions of the largest banks.

Stress tests each year have upheld the original principle of transparency around the capital adequacy of our largest banks. Stress tests results should allow investors, counterparties, analysts and markets to make more informed judgments about the condition of banks. Along with other regulatory measures, this transparency increases market discipline and it subjects the Federal Reserve to greater outside scrutiny and analysis. Accountability is important not only for the usual reasons that apply in a democracy but also, in this case, because stress tests can only be effective when the public has confidence in the Fed's evaluation of the capital adequacy of banks. In effect, stress tests are also a test of the Fed's supervision of large banks.

In these remarks, I will first sketch out how changes in regulation, risk management, the economy, and overall financial stability have prompted alterations to stress tests over the past decade. Much of that change has enhanced transparency, which is a founding principle for stress tests. I will then suggest some ways in which the effectiveness of stress testing can be further enhanced with greater transparency.

Ten years ago, in May of 2009, the Fed and the Treasury Department released the first stress test results under the Supervisory Capital Assessment Program (SCAP). At that moment, the U.S. economy was in free fall. The United States had lost an astonishing three million jobs in the previous four months. One significant reason for these losses was that many businesses were severely constrained in their access to funding and found it impossible to predict when that access might improve. The goal of the first test was urgent and simple: to restore confidence in the 19 large banks that then accounted for two-thirds of the assets in the banking system. In fact, simply announcing in March that there would be tests helped stabilize bank finances. That improvement continued after the results in May outlined the quite feasible steps for raising additional capital that the banks would need to take, and did take, to be able to continue lending if adverse conditions continued.

Challenging conditions did continue, but the stress tests and other actions taken in the first half of 2009 marked a turning point. The recovery from the Great Recession began in July, as the financial system came back to life, and then steadily strengthened.

The principles that made that first test so effective were independence and transparency. For the first time, an independent authority, the Federal Reserve, would seek to independently assess risks.<sup>1</sup> Just as important, the details of that assessment would be shared with the public, an extent of transparency that until then wasn't characteristic of bank supervision but would become the hallmark of the regulatory framework erected in response to the crisis. The first tests relied heavily on banks' internal risk models, but they still represented a huge step in independence in providing the public with an assessment of the health and resiliency of large banks. Transparency facilitated both market discipline and accountability. The information provided to the public under the SCAP stress test reinforced the entire enterprise of estimating the capital shortfall faced by major banks. It held the banks accountable for information on their capital adequacy and required them to fill the capital hole.

The next big step for stress testing came with its integration with the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), beginning in 2011. One big change from the initial SCAP test was that stress tests were no longer a one-time emergency measure intended to restore confidence in major financial institutions. Instead, they became a recurring, ongoing process intended to maintain confidence in major institutions. Second, stress tests were no longer a discretionary exercise by supervisors—under Dodd-Frank, they became the law of the land. And third, when they were integrated into CCAR, stress tests became part of a comprehensive—it's the first C in CCAR—framework for capital planning that more closely connected capital regulation to risk management of banks and overall supervision.

These were changes, but with the effect of reinforcing the founding principles of the SCAP test. Transparency was enhanced when stress tests became mandatory, recurring events and the public could depend on continuing to have access to information about banks' capital adequacy. Also, the independence of those judgments was enhanced when Congress made them a statutory responsibility for the Fed and when they were integrated into our CCAR framework.

Further changes to stress testing have likewise reinforced the original goals. Stress testing scenarios have become richer and more challenging, providing more information about how banks would deal with a range of adverse developments and, for example, exploring the effects of more differentiated risks that are not tied to the business cycle. Large trading banks now face an instantaneous shock to their trading assets, and many participants in the stress tests now must address how they would respond to the failure of their largest counterparty.

Our stress tests demonstrate that banks have now built enough capital to withstand a severe recession. The capital-building phase of the post-crisis era is now complete, but as part of CCAR, stress testing continues to contribute to the significant and ongoing improvement

since 2009 in risk management by banks. The original reason for the qualitative objection aspect of stress testing was to provide incentives for banks to address the risk-management shortcomings that the Federal Reserve had observed during the financial crisis. For example, many firms supervised by the Federal Reserve had substantial deficiencies in their ability to measure, monitor, and manage their risks. These shortcomings made it difficult for banks to accurately report their risk exposures to the Board, and consequently, threatened to undermine the credibility of the stress tests, which were, and remain, dependent on data from the banks.

Since the beginning of CCAR in 2011, large banks have significantly improved their risk-management and capital-planning processes. The qualitative assessment conducted as part of the 2018 and 2019 CCAR cycles found that most firms either meet or are very close to meeting the Federal Reserve's supervisory expectations for capital planning. Large banks have improved the methods they use to identify their unique risks, now use sound practices for identifying and addressing model weaknesses, and have strong processes in place to evaluate their capital positions on a forward-looking basis. While we continue to perform a qualitative assessment and ensure that progress is retained, the improvements led the Federal Reserve to conclude that for most banks this assessment can be incorporated into our regular supervisory practices. The evolution of our qualitative assessment reflects the experience of the past 10 years of stress testing, and in particular, the great improvement in risk management by large banks and the cumulative effect of the Fed's improved supervision of large institutions. As I said earlier, for stress testing to remain effective, it must respond to changes in the economy, the financial system, and risk-management capabilities.

The changes to CCAR have occurred in the context of a similarly dramatic improvement in the strength and resilience of the financial system. The firms have more than doubled their capital since the first round of stress tests in 2009. Since that time, the common equity of the largest 18 firms has increased by more than \$650 billion.

Let me now turn to the most recent changes to CCAR and stress testing and put them in the context of the history I have just related. Congress revisited large bank supervision last year in S. 2155, yet the legislation it passed reaffirmed the important role of stress testing. This shouldn't be surprising, because the experience of stress testing over the last 10 years has demonstrated that it is a highly useful element of large bank supervision and the promotion of financial stability.

Something else that shouldn't be surprising is that this experience has revealed that periodic stress testing has turned out to be a less useful supervisory tool to evaluate the risks of smaller and less complex financial institutions. Congress made use of this experience by raising the threshold for stress testing to \$100 billion in assets and providing more flexibility for the Fed to tailor stress testing for all firms. This step has, once again, advanced the principles demonstrated in the first stress test and ever since. It has increased transparency because incorporating and disclosing what we have learned about the varying effectiveness of stress testing at different types of institutions is making stress testing more effective. The accountability of the Fed is enhanced when we are seen taking on board what we have

learned through successive cycles of stress tests, and this strengthens the independence and credibility of our judgments. For those of us who believe stress testing should remain central to supervision and promoting financial stability, it is vital that an adjustment such as this takes place as appropriate.

With that in mind, let me review recent changes and proposed changes to the Federal Reserve's stress testing. These changes are designed to make CCAR more transparent and simple and to feature less unnecessary volatility.

The first principle is transparency. We have taken a number of recent steps to enhance the transparency around our models and the stress testing process more generally. Earlier this year, the Board published enhanced disclosures on two of the key models that we use in stress testing. In addition, the Board published estimated loss rates for groups of loans with distinct characteristics, to show how supervisory models treat specific assets under stress. We will publish disclosures about two additional models in 2020 and each year thereafter until we have provided transparency about all our stress test models. At the same time, we published a new policy statement on our approach to supervisory stress testing. Among other things, the statement emphasizes the importance of independence and stability to the credibility of our stress tests.

We are currently considering options to provide additional transparency regarding scenarios and scenario design and I expect that the Board will seek comment on the advisability of, and possible approaches to, gathering the public's input on scenarios and salient risks facing the banking system each year. Such a proposal may also provide additional details about the scenario design features that underpins each year's scenarios, and a range of other enhancements.

Some argue that the greater transparency and disclosure promoted by recent changes and proposed changes to stress testing amounts to providing banks with the answers to the tests.<sup>2</sup> This both overstates the extent of disclosure involved and misunderstands what we are trying to accomplish in stress testing—goals that haven't changed since the spring of 2009.

If the goal were only to conduct a test that was difficult to pass—like the qualifying exams for some of the more esoteric and restrictive high-IQ societies—then trying to explain principles, scenario design, and how models work would be inappropriate. If the measure of success for the Fed in administering a stress test was simply how many banks failed, then greater transparency would indeed be a mistake. But that is not the purpose of stress testing, and it never has been.

The vitally important goal is to improve and sustain good risk management and capital planning at the individual institutions we supervise and to promote the stability of the financial system. Like a teacher, we don't want banks to fail, we want them to learn. In this case, we want them to learn good risk management in the context of forwardlooking capital planning. This will provide the public with more information about the capital planning of

major banks, and about how the Federal Reserve views good capital planning and risk management, bolstering our credibility.

The second principle reflected in recent changes to stress testing is simplicity. One important proposal—what we are calling the stress capital buffer—would simplify the Fed's large bank capital rule by integrating the stress testing process with our traditional regulatory capital rules. Our regulatory capital rule includes both minimum capital requirements and a buffer that sits on top of those minimum requirements. The buffer serves as an early warning to a firm and to supervisors, and it requires the firm to reduce its capital distributions as the firm approaches the minimum requirements. Integrating these two standards is a natural evolution of CCAR away from its origins during the crisis, when such tailoring was impractical and policy makers had not yet considered the approach of a regulatory capital buffer on top of a regulatory capital minimum.

The stress capital buffer would result in a more transparent and simplified system of regulatory capital requirements because a firm will be held to a single, integrated capital regime. The stress capital buffer would not reduce the stringency of the regulatory capital framework for large banks, but it would effect a substantial simplification of that framework. By my math, the number of different capital requirements applicable to large banks would fall from 18 to eight and the number of different total loss absorbing capacity requirements for large banks would fall from 24 to 14. I expect that we will move forward with a revised stress capital buffer proposal in the near future, reflecting many of the comments received on our original proposal.

The third principle addressed by the recent changes is volatility. When I think about volatility in stress testing, I want to distinguish what I consider to be useful variation in the tests, in the form of exploration of salient risks, from what I consider to be less useful variation, in the form of unexpected swings in capital requirements that don't have any particular relationship to changing risks at individual firms. In addition, one source of volatility in the tests comes from the fact that banks are forced to do their capital planning before they get the results of our tests. I will address each of these concerns in turn.

In distinguishing useful from less useful volatility, one option to address the yearover-year volatility of the tests would be to average the results of the tests from the previous year or years. This would not affect the overall stringency of the tests but, mathematically, would mean that no single year could have an outsized influence on the amount of capital that a bank is required to maintain. The potential downsides to this approach include the reduced risk sensitivity that a bank may experience to a particular test and potential technical challenges associated with changes to a bank's balance sheet and earnings. Bearing in mind these potential challenges, I believe more thinking and discussion of this issue would be fruitful.

With respect to the second concern, as I have said before, I believe it more rational and logical for firms to be able to plan for their capital needs with the benefit of the results of our tests. Given the huge strides that the banks have made in their capital planning and in

meeting our expectations, I view the risk of banks backsliding in this regard to be minimal because it would be evident in the next test. Our capital-planning expectations will not decline, and we will continue to use the supervisory process to enforce these expectations. It is my hope that greater transparency can play a role in other parts of our supervisory process—for example, by allowing other aspects of bank supervision to benefit from public input. Greater transparency for supervision is in keeping with one of the biggest improvements to the regulatory framework and to stress testing since the financial crisis. I believe the changes and proposed changes to stress testing that I have discussed today reinforce the founding principles of the first test, administered in the challenging and uncertain spring of 2009, and reflect what we have learned each year over the decade since then. That process of learning and refining should and must continue in order to keep stress tests as relevant and effective as they have been in helping to reduce the chances of another severe crisis.

## References

1. On May 7, 2009, the results of the Supervisory Capital Assessment Program were announced by the Federal Reserve Board, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency.
2. Mark J. Flannery, Simon H. Kwan, and Mahendrarajah Nimalendran, "Market evidence on the opaqueness of banking firms' assets," *Journal of Financial Economics* 71, no.3 (2004): 419–60.

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**Fonte:** QUARLES, Randal K. *Stress Testing: A Decade of Continuity and Change*. Disponível em: <<https://www.federalreserve.gov/newsevents/speech/quarles20190709a.htm>> Acesso em: 10 de julho de 2019

## **Luis de Guindos: Macroprudential policy ten years after the crisis**

*Keynote speech by Luis de Guindos, Vice-President of the ECB, at the CIRSIF Annual International Conference 2019 "Financial Supervision and Financial Stability Ten Years after the Crisis: Achievements and Next Steps", Lisbon, 4 July 2019*

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Since the financial crisis, the euro area's institutional architecture has evolved significantly. Back in 2010, in the midst of the crisis, we created the predecessor of today's European Stability Mechanism (ESM) to provide assistance to euro area countries experiencing or threatened by severe financing problems.<sup>[1]</sup>

At the same time, the European System of Financial Supervision was introduced, aimed at ensuring consistency and appropriate financial supervision in the EU. It includes the European Banking Authority (EBA), which provides harmonised prudential rules for financial

institutions in the EU, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority. Since 2010, the European Systemic Risk Board (ESRB) brings these institutions together with the national supervisory authorities and central banks to share their assessments on the financial system and devise consistent supervisory responses for the entire EU.

Since the establishment of the Single Supervisory Mechanism in 2014, the ECB is the European banking supervisor and closely cooperates with the three European Supervisory Authorities, and especially with the EBA. Should banks fail, the Single Resolution Board ensures their orderly resolution with as little impact as possible on the real economy and public finances thanks also to the funds available from the Single Resolution Fund. Only last month, the Eurogroup agreed to equip the Single Resolution Fund with a backstop financed by the ESM to further strengthen the European financial architecture.[2]

Looking beyond microprudential supervision, we have built up the macroprudential policy toolkit over the past ten years, to address risks of a systemic nature. National authorities and the ECB can deploy pre-emptive macroprudential tools to mitigate risk-taking and enhance the resilience of the financial system, while the ESRB can issue warnings and recommendations.

In my remarks today, I will discuss the financial stability challenges facing the euro area and will focus on the relevance of countercyclical macroprudential policy to safeguarding financial stability and supporting prudent lending, by banks and non-banks, throughout the cycle. So far, macroprudential policies have focused on the banking sector. But the financial system is broader than that. Non-bank financial entities such as investment funds, insurance companies and pension funds also take on risks and can amplify the wider financial cycle. So it is more important than ever that macroprudential policies are broadened to cover these non-bank financial entities as well.

### **Financial stability and macroprudential policy in the Economic and Monetary Union**

The euro area's ongoing economic recovery faces renewed global headwinds that are weighing on the economic outlook. Uncertainties related to the rising threat of trade protectionism, vulnerabilities in emerging markets and geopolitical factors, including those related to Brexit, make the economic environment more challenging.[3]

In this environment, the ECB's accommodative monetary policy is necessary for inflation to remain on a sustained path towards levels that are below, but close to, 2% over the medium term.[4] At the same time, the environment indicates that risks to economic growth are tilted to the downside.

This reinforces the need to strengthen the balance sheets of our financial and non-financial firms to withstand any shocks that may occur. Fortunately, banks have done exactly that over the last decade. Capital ratios of euro area systemic banks increased from 10.4% at the end of 2010 to 14.3% by the end of last year (in terms of common equity tier 1). This increase has been facilitated by the general recovery, supported by the ECB's

accommodative monetary policy, and is a reaction to increased market pressures and additional macroprudential requirements.

Indeed, macroprudential policy aims to maintain a strong and stable financial system. It has become a crucial complement to the ECB's monetary policy which is geared towards achieving price stability. While the current accommodative monetary policy is supporting the economic recovery, it may generate undesired side effects in the form of excessive risk-taking. Macroprudential policy can counter these excesses with its targeted toolkit. By imposing additional requirements, it can restrain lending to excessively risky borrowers or create the necessary loss absorption capacity in specific sectors or countries.

### **Institutional set-up of macroprudential policy within European banking supervision**

This more targeted application of macroprudential policy to individual countries is also reflected in its institutional set-up. National authorities are first in line to counter emerging systemic risk in a timely manner by deploying the available instruments. They have detailed knowledge of their domestic banking systems and financial structures. The ECB, in turn, complements the national authorities with its cross-country perspective. It can identify regulatory differences and counter potential inaction bias by the national authorities. To operate this two-tier set-up effectively, the SSM Regulation provides that national authorities must notify the ECB of macroprudential measures they intend to implement. The ECB's Governing Council may object to these measures and, if deemed necessary, set higher macroprudential requirements than those set by national authorities, commonly known as "top-up".<sup>[5]</sup>

The "top-up" option is considered a last resort. There are two main reasons for this. First, national authorities being responsible for addressing financial imbalances creates a clear expectation that they do so in a timely manner. If national macroprudential authorities can act with a complete macroprudential toolkit to fulfil their mandates, the scope for the ECB to set higher requirements is more focussed to address risks from cross-country spillovers to secure a consistent application across countries. Second, macroprudential policy authorities, represented by national central banks and supervisors, come together at the ECB's Financial Stability Committee (FSC). The FSC serves as the central platform of exchange at the technical level for authorities to share their experience in financial stability and macroprudential policy. The Committee has achieved important milestones in increasing data coverage and quality, assessing systemic risk and developing calibration strategies for macroprudential instruments.

This holds also true for those instruments that are not fully harmonised at EU level. For example, borrower-based measures such as loan-to-value, loan-to-income or debt service-to-income can limit the leverage of households and non-financial corporations. These instruments are thought to be the most effective macroprudential instruments for curtailing excessively risky credit origination. Indeed, because of their effectiveness, 13 countries have already implemented measures targeting the specificities of their real estate markets.

Nevertheless, some euro area countries do not have the full legislation in place to deploy all borrower-based measures.[6] And even if they do, the institution that decides on borrower-based instruments is not always the central bank or the supervisory authority. This creates an additional hurdle to deploying the best macroprudential policy responses. As a result, some macroprudential authorities use recommendations to the financial institutions as a second-best option.

Beyond the possibility of using borrower-based measures to address real estate risks, Belgium and Finland have increased the risk weights on banks' mortgage exposures.[7] These measures focus on banks' resilience to potential losses on their outstanding stock of mortgage loans.

Systemic risks may also arise from sources other than real estate. Therefore, national authorities have increased the combined buffer requirements, which include five different buffer types.[8] First, the capital conservation buffer of 2.5% is applied to all banks to maintain capital in the banking system.[9] Second, to mitigate the "too-big-to-fail" problem, the buffer for global systemically important institutions is currently applied, in the range of 1-2%, to eight globally important banks in France, Germany, Italy, the Netherlands and Spain. Third, buffers of up to 2% have been applied to more than 100 other (or domestic) systemically important institutions across the euro area. Fourth, four countries are addressing structural risks by applying the systemic risk buffer either to individual institutions, in the case of Austria, the Netherlands and Slovakia, or at the country level in the case of Estonia.

The fifth buffer is the countercyclical capital buffer (CCyB). It is central to a countercyclical macroprudential policy as it helps ensure financial stability throughout the cycle. By raising capital requirements as imbalances are building up, it increases bank resilience well ahead of potential shocks. In a downturn, the CCyB can be released to give banks the necessary capital space to support lending to the real economy.[10] So far, seven euro area countries have announced that they will activate or increase CCyB rates of up to 1.5%.[11]

The ECB's view is that banks' overall capital levels are currently appropriate. Nevertheless, the current buffer calibrations prevent them from being used countercyclically throughout the cycle. The limited size of the CCyB calibrations restricts the possibility for releasing it to support lending to the real economy if the cycle turns. As macroprudential authorities, we are therefore continuing to review the implementation and scope of the available instruments. In this respect, we very much welcome last month's publication of the new Capital Requirements Directive (CRD V) and Capital Requirements Regulation (CRR II) to strengthen the macroprudential toolkit.[12]

### **Role of the non-bank financial sector and macroprudential policy**

Despite the many achievements in the regulatory reform process since the crisis, there are areas where more work needs to be done. In my view, the regulatory framework for the non-bank financial sector is one of these areas. First of all, the sector has grown significantly in

size and importance. Second, it is accumulating ever more risks on its balance sheet. And third, work on the macroprudential framework for this sector is still in its infancy.

Let me start with the growing size of the sector. In the euro area, total assets held by non-banks have almost doubled over the last ten years, growing from €23 trillion in 2008 to €42 trillion in 2018. While the size of the banking sector stagnated over this period, non-banks currently account for around 55% of the euro area financial sector.<sup>[13]</sup> The fast growth of non-banks reflects their increasing role in financing the euro area real economy. Whereas ten years ago, non-banks accounted for 14% of the euro area financial sector's loans to non-financial corporations, they now account for twice that share. Moreover, non-banks provide a steady net flow of financing to non-financial corporations through the purchase of debt securities. In the ten years prior to the crisis, euro area non-financial corporations obtained only 10% of their credit by issuing debt securities, while this share increased to more than 50% in the decade after the crisis.

By diversifying the financing sources of the real economy, the non-bank financial sector plays an important role in financial intermediation. It provides an additional source of financing and can ultimately help to smooth shocks in the euro area. The growing relevance of non-bank intermediation can, however, create potential new vulnerabilities.

In their search for higher yields, non-banks have accumulated more risks in their investment portfolios in recent years. For instance, more than half of the bonds held by euro area investment funds are BBB-rated or lower. For euro area insurers this share is somewhat smaller, at around 40%, but it has increased by more than 5 percentage points over the last five years. Insurers have also been venturing into alternative asset classes such as alternative, infrastructure and private equity funds, loans and real estate holdings. Their exposure to these assets has reached almost 10% of total investment and is expected to rise further.<sup>[14]</sup>

As some of these assets are highly illiquid, the portfolio shift towards these assets may also increase insurers' liquidity risk beyond credit risk. But this is only one example, where the credit risk on non-banks' balance sheets is coupled with liquidity risk. In fact, liquidity risk is particularly an issue for some bond and equity funds that invest in less liquid assets, while offering short-term redemptions to their investors. These funds are vulnerable to sudden changes in investor sentiment, so-called "run risks". Some recent cases were a reminder that investors in less liquid funds might indeed run if they fear deterioration in asset quality or liquidity.<sup>[15]</sup> While recent instances happened in a generally stable market environment and did not have systemic repercussions, liquidity problems might have been larger in an adverse market environment and with many funds affected simultaneously. If anything, the liquidity mismatches observed in bond and equity funds call for greater scrutiny of market practices and a possible review of the regulatory framework to ensure the sector's resilience also in stressed market conditions.

More generally, through increased risk-taking and leverage, non-banks may currently be contributing to the cyclical under-pricing of risks and the amplification of asset prices. If these

risks were to unwind in a disorderly manner, this could lead to funding flows drying up and affect the funding conditions of the real economy more broadly. Moreover, distress in the non-bank sector could spread to the banking sector as well, due to the strong links between the two. For instance, euro area non-banks hold over one quarter of bonds and shares issued by euro area banks.

I have argued in the past that, from a regulatory perspective, we need to establish at least two lines of defence for evolving risks. First and foremost, the non-bank financial sector needs to have solid prudential standards. But this will not be sufficient if risks evolve more broadly and across institutions. We will also need an extension of the macroprudential toolkit to the non-bank financial sector, in order to provide the authorities with the means to address risks at system level. While the macroprudential framework for banks is relatively well developed and provides authorities with tools to address cyclical and structural systemic risks, the framework for non-banks is still in its infancy and needs to be further developed.

There are substantial differences between banks and non-banks. When we look at financial stability concerns in non-banks, we are looking less at the risk-bearing capacity of the individual institution's balance sheet and more at the potential for contagion and shock amplification through the system and amplification of the broader financial cycle. So the key risks that we look at relate to liquidity, leverage, procyclicality and interconnectedness. A macroprudential framework for non-banks would need to identify and address the key fragilities and externalities stemming from the non-bank sector, and provide the appropriate tools for authorities to achieve this in an efficient and effective manner.

Such a framework should support the beneficial role that non-banks play in financial intermediation and ensure the sustainable development of non-bank financing. On a note of particular relevance in a monetary union, it would thereby help reap the full benefits of a deep and integrated European capital market. In this respect, the ECB continues to support the further development and deepening of EU capital markets through the capital markets union (CMU), not least in the light of the approaching exit of the United Kingdom.

The United Kingdom's departure from the EU's Single Market will, by its very nature, affect the shape of Europe's future financial market architecture. Non-bank financing of the euro area economy is no exception to this, particularly given the substantial role played by London as a financial hub for European capital markets. Planning by the financial industry suggests that Brexit may result in a substantial relocation of activity to a number of different euro area countries, which may lead to a multi-centric European financial system. In a financial system with a number of increasingly important hubs rather than one dominant centre in London, it will be more important than ever that these hubs can interact with one another efficiently. This will require policies that foster the integration of EU capital markets by addressing barriers to integration and encouraging supervisory convergence. So Brexit is both a challenge and an impetus to our pursuit of the ambitious plans laid out under the CMU.

## **Conclusions**

Let me conclude.

The institutional architecture of the euro area has markedly strengthened in the last decade. With important new institutions, we have seen more robust supervision of financial institutions and the deployment of macroprudential instruments. This has contributed to strengthening our financial system. But we still need to enhance the countercyclical use of our macroprudential instruments by providing adequate macroprudential space to support robust lending and the real economy throughout the cycle. Equally, we urgently need to develop and, where appropriate, deploy the necessary macroprudential instruments for non-banks as well. Finally, we must also pursue the ambitious plans laid out under the CMU to create a deep and integrated European capital market. All of this will allow us to improve financial stability across the wide array of financial institutions and markets that make up the financial system.

## References

[<sup>1</sup>]See the history of the construction of the ESM in: European Stability Mechanism (2019), *Safeguarding the euro in times of crisis: The inside story of the ESM*.

[<sup>2</sup>]Klaus Regling at press conference after Eurogroup meeting, Luxembourg, 14 June 2019: <https://www.esm.europa.eu/press-releases/klaus-regling-eurogroup-press-conference-19>

[<sup>3</sup>]For additional details on the risks, see ECB (2019), *Financial Stability Review*, May.

[<sup>4</sup>]See Draghi, M. (2019), “Twenty Years of the ECB’s monetary policy”, speech at the ECB Forum on Central Banking, Sintra, 18 June.

[<sup>5</sup>]See Decision of the European Central Bank of 22 January 2014 amending Decision ECB/2004/2 adopting the Rules of Procedure of the European Central Bank (ECB/2014/1).

[<sup>6</sup>]In December 2016, the ECB’s Governing Council issued a statement calling for the implementation of legislative frameworks for borrower-based measures in all euro area countries.

[<sup>7</sup>]On the basis of Article 458 of the CRR, Belgium has implemented a 5 percentage point add-on and a 1.33 risk weight multiplier for exposures secured by domestic real estate assets, Finland has implemented a risk weight floor of 15% on domestic real estate exposures, and Luxembourg has recommended a 15% floor on the same exposure.

[<sup>8</sup>]For a detailed overview of macroprudential measures, see the ECB’s website (updated quarterly).

[<sup>9</sup>]The CCoB is based on Article 129 and 160 CRD IV, transposed in national legislation. Exemptions for small and medium-sized investment firms are possible. The CCoB is part of the combined buffer requirements to which G-SII, O-SII, Systemic risk buffer and countercyclical capital buffer pertain.

[10]See Darracq-Pariès, M., Fahr, S. and Kok, C. (2019), “Macroprudential space and current policy trade-offs in the euro area”, *Financial Stability Review*, ECB, May.

[11]As of 30 June 2019, seven countries have announced the following rates: Belgium (0.5%), France (0.5%), Germany (0.25%), Ireland (1.0%), Lithuania (1.0%), Luxembourg (0.25%) and Slovakia (1.5%). Buffer requirements are implemented with a 12-month lag.

[12]See Regulation (EU/2019/876) of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, large exposures, report and disclosure requirements, and Regulation (EU/648/2012) (CRR II).

[13]Excluding central banks.

[14]See Fache Rousová, L and Giuzio, M. (2019), “Insurers’ investment in alternative assets”, box 9 of *Financial Stability Review*, ECB, May.

[15]For instance, Neil Woodford’s Equity Income Fund, an equity UCITS fund which invests in supposedly liquid assets, had to suspend withdrawals after large outflows. In other recent case, following concerns over asset illiquidity, outflows accelerated from bond funds managed by Natixis-owned asset manager H2O affecting Natixis’ stock price.

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