BANCO DE ESPAÑA
Eurosistema

INTERNATIONAL COORDINATION IN DEALING WITH SOME FINANCIAL STABILITY CHALLENGES AHEAD

CIII REUNIÓN DE GOBERNADORES DE BANCOS CENTRALES DEL CEMLA

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OUTLINE

- General overview of the European Financial Architecture
- Macroprudential policies: spillovers and leakages
- Fintech: level playing field & technological neutrality
- Green Finance: measuring the risk and developing financial markets
- The role of supranational authorities to improve coordination at a global level

THE THREE PILLARS OF BANKING UNION IN EUROPE

	Supervision	Resolution	Deposit Guarantee
Normative Framework	*SSM Regulation* *Supervision areas ECB* *CRD IV- CRR* *EBA – Single Rule Book*	Resolution Directive (BRRD) Regulation SRM	Directive Deposit Guarantee (DGS)
Institutional Framework	Single Supervision Mechanism 04.11.2014	Single Resolution Mechaninsm 01.01.2015	Common Framework for Deposit Portection

Macroprudential Policy: European Systemic Risk Board (ESRB)

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SPILLOVERS AND MACROPRUDENTIAL POLICY

- **National macroprudential policies can not be fully effective unless are implemented in the whole financial system (leakages through foreign branches).**

- **National macroprudential measures may have cross-border or cross-sectoral (unintended) consequences (spillovers).**

- **Reciprocity arrangements between countries have a twofold objective:**
  - *contribute to (i) enhancing their effectiveness and consistency of the treatment of risks while (ii) limiting potential negative spillovers.*

- **But are these leakages and spillover effects relevant?**
  - *Hard to document since they arise in different ways*
  - *And they seem to be very heterogeneous (depending on instrument, banking model, banks balance sheet strength, state of the economy…)*

THE EUROPEAN APPROACH TO MACROPRUDENTIAL RECIPROCITY

- **The current legislation applicable throughout the EU envisages the application of mandatory/ voluntary reciprocity for macroprudential instruments**

    - The CRR/CRD IV foresees mandatory reciprocity for a few instruments (for example CCB)

    - In December 2015 the ESRB issued a Recommendation on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures

    - The ESRB framework foresees the reciprocation of exposure-based measures taken by Member States

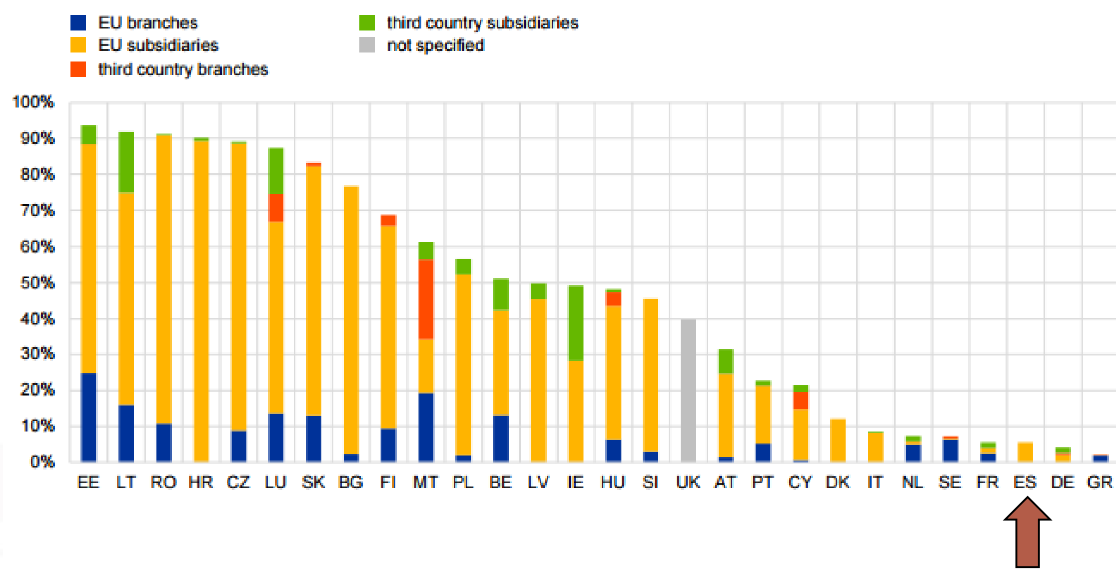
    - Also in December 2015, the ESRB issued a Recommendation on the recognition and setting of the countercyclical buffer for countries outside the EU ("third countries")

CROSS-BORDER LENDING IN EUROPE

- **In a number of EU Member States, lending provided either through foreign branches/subsidiaries or via direct cross-border loans is significant**

Market share of foreign banks in EU countries

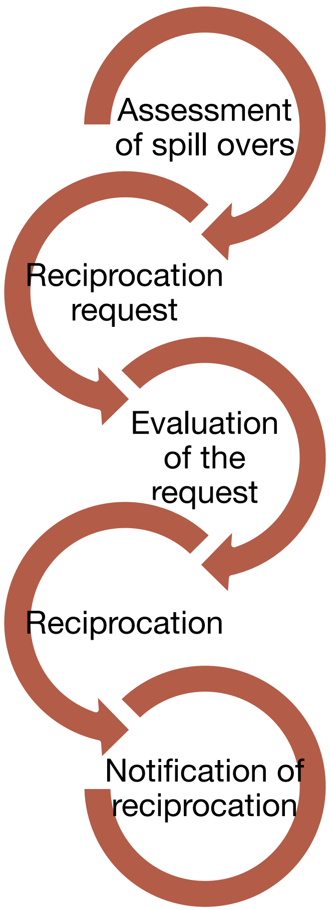
(2016-Q3)



Source: ECB and ECB/ESRB calculations.

Notes (left chart): Based on Consolidated Banking Data. The size of the bubbles corresponds to the ratio of domestic to total claims of a country's consolidated banking sector. The thickness of the arrows depends on the share of bilateral foreign claims in the total claims of the banking sector extending the loans. Arrows are not displayed in cases where the corresponding ratio is below 5%. Due to the use of consolidated data, cross-border claims also include banks' exposures to other countries in the EU through the presence of subsidiaries in those countries. Data for UK not available.

ESRB RECOMMENDATION ON RECIPROCITY



- **The ESRB framework foresees an iterative process for the implementation of voluntary reciprocity**
  - National authorities must regularly assess potential cross-border spillovers
  - Must notify the ESRB about adopted measures, and ask for reciprocity
  - When the ESRB finds the reciprocity request well substantiated, it will issue an amendment to the recommendation
  - National authorities must notify the ESRB when they reciprocate.
- **The experience with the implementation of voluntary reciprocity is fairly limited. Only two measures liable to reciprocation in 2016:**
  - Belgium: 5 pp add-on to the risk-weights of Belgian mortgage exposures of IRB banks
  - Estonia: 1% systemic risk capital buffer on Estonian exposures
  - None of these was reciprocated by Spain, due to non-materiality of exposures.

CCB FOR THIRD COUNTRIES

- **European authorities may set a CCB for their exposures to third countries (non EU) if they deem it necessary**
- **The goal of the ESRB recommendation is twofold**
  - Spillovers: avoid that unsustainable credit developments in a third country generate a systemic risk for European countries
  - Level playing field: ensure a consistent treatment of the CCB for third countries among European authorities, so that European banks operate under the same conditions
- **European authorities shall identify each year the most material third countries, and follow their credit markets closely**
  - For the whole EU, the ESRB has initially identified Brazil, China, Hong Kong, Turkey and the US
  - Banco de España has initially identified Brazil, Chile, Mexico, Turkey and the US

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- **Financial technology innovations pose both opportunities and challenges to regulators and supervisors**
  - How to strike a right balance between keeping a sound and safe financial system and supporting innovation?

- **An increasing number of regulators have started to promote regulatory initiatives to facilitate the innovation inside their borders**

- **Although, innovative products and services are being mainly developed at a national level, Fintech has the potential to expand worldwide**

- **The European Commission has recently argued in favor of regulation and supervision of Fintech under three general principles:**
  - same services and same risks, same rules
  - technology neutrality
  - a risk-based approach.

FINTECH: REGULATORY FRAMEWORK

- **Fintech developments raise a wide range of issues that may involve different public authorities**

- **Financial technology has the potential to change business models, which may result in gaps in the regulatory framework that deserve close attention**

- **Cooperation becomes necessary to:**
  - Monitoring the activity (since new players could provide services through the borders).
  - Implement initiatives to promote technological change, avoiding a race to the bottom among jurisdictions
  - Understand some of the financial stability risk entails with new technologies (cibersecurity, data and consumer protection, risk management tools, the effects for the regulated traditional sector…)

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Two areas where coordination could be important. Both are important for Banks, that play a key role in the funding of the projects needed to meet the Paris agreement to limit global warming:

I. The development of a standarized green bond market, to which banks may contribute besides providing green loans to companies:

- Issuance of green bonds was $ 84 bln. in 2016, the highest amount on record (almost 40% by banks), but still a small market.
- No common widely accepted definitions yet: Standarization needed to increase liquidity and to reduce transaction costs (some initiatives: ICMA Green Bond Principles).
- Promoting a common standards on banking issuance of green bonds could be critical to develop a market
- In particular for some instruments where banks are the main issuers (Green covered bonds and green securitizations).

II. Promoting awareness towards environmental risk: *"Climate-related risks are a potential driver of losses for banks and a danger for the financial stability (FSB, 2015)"*. Challenges:

1. Identification and quantification of climate-related risks affecting assets.
   - The G20 GFSG report has identified several barriers for a proper *Environmental Risk Analysis*.
2. Inconsistent and insufficient disclosure of information about theses risks hinders market discipline. Most important initiatives:
   - Globally: FSB TCFD recommendations.
   - In Europe: Directive2014/95/EU.
3. Regulators and supervisors could include climate-related risks in the evaluation of banks:
   - ESRB recommendations to include them in future stress tests.
   - In general, clear policy signals encouraging banks to assess environmental risks (GFSG).

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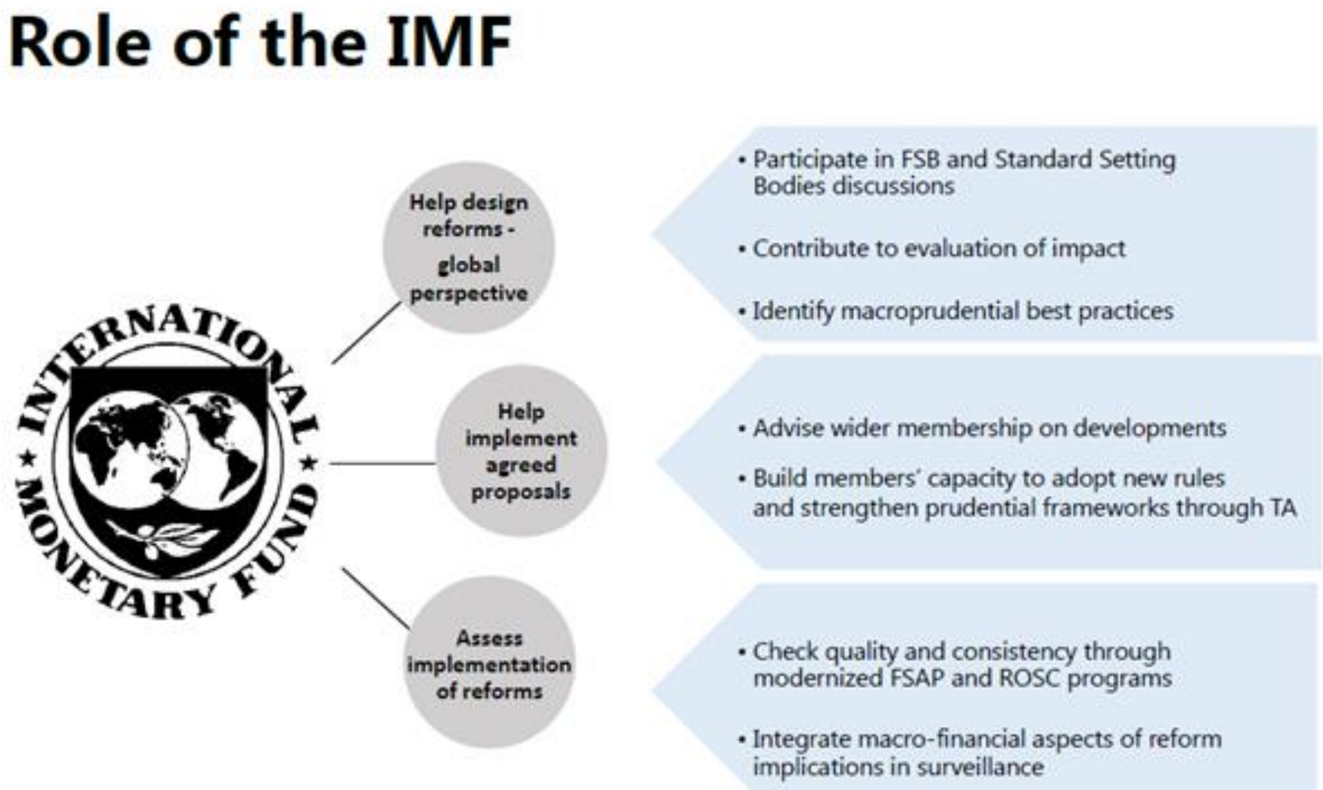
The role of multilateral institutions

- Full timely and consistent adoption of regulatory standards becomes critical. The important role of Basel (RCAP process), FSB (thematic reviews)
- IMF- Establishment of High Level Advisory Group on FinTech, march 2017
- IMF MD states at the end of 2015 the role of the IMF in helping its members address those challenges of climate change



ADDITIONAL SLIDES

BANCO DE ESPAÑA
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INTERNATIONAL AFFAIRS

THE SINGLE SUPERVIRSORY MECHANISM (SSM)

- **Legal Framework:**
  - Provides ECB with broad supervisory competences
  - Determines the distribution of competences between ECB and National competent authorities (NCAs)

- **Governance:**
  - ECB Supervisory Board

- **Perimeter:**
  - Euro area (optional to other European countries)
  - 125 significant banks (close to 85% of assets in the euro area)
  - The other banks continue to be supervised by NCAs in close cooperation with SSM

- **Guide to Banking Supervision**
  - Harmonize supervisory practices and procedures

THE SINGLE RESOLUTION MECHANISM (SRM)

- **Legal Framework:**
  - SRM: Single Resolution Board and Single Resolution Fund

- **The SRB together with the national resolution authorities (NRAs) of participating countries :**
  - Ensures the orderly resolution of failing banks with minimum impact on the real economy and the public finances of banking union countries
  - Manage the Single Resolution Fund
  - Determine criteria and monitor the activity of NRAs

- **Single Resolution Fund:**
  - Gradual contributions from credit institutions (up to 1% of all covered deposits)

- **SRM is fully operative from January 2016**