THE REGULATORY AND SUPERVISORY LANDSCAPE: A GLOBAL PERSPECTIVE

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1 **Financial Stability: global assessment**

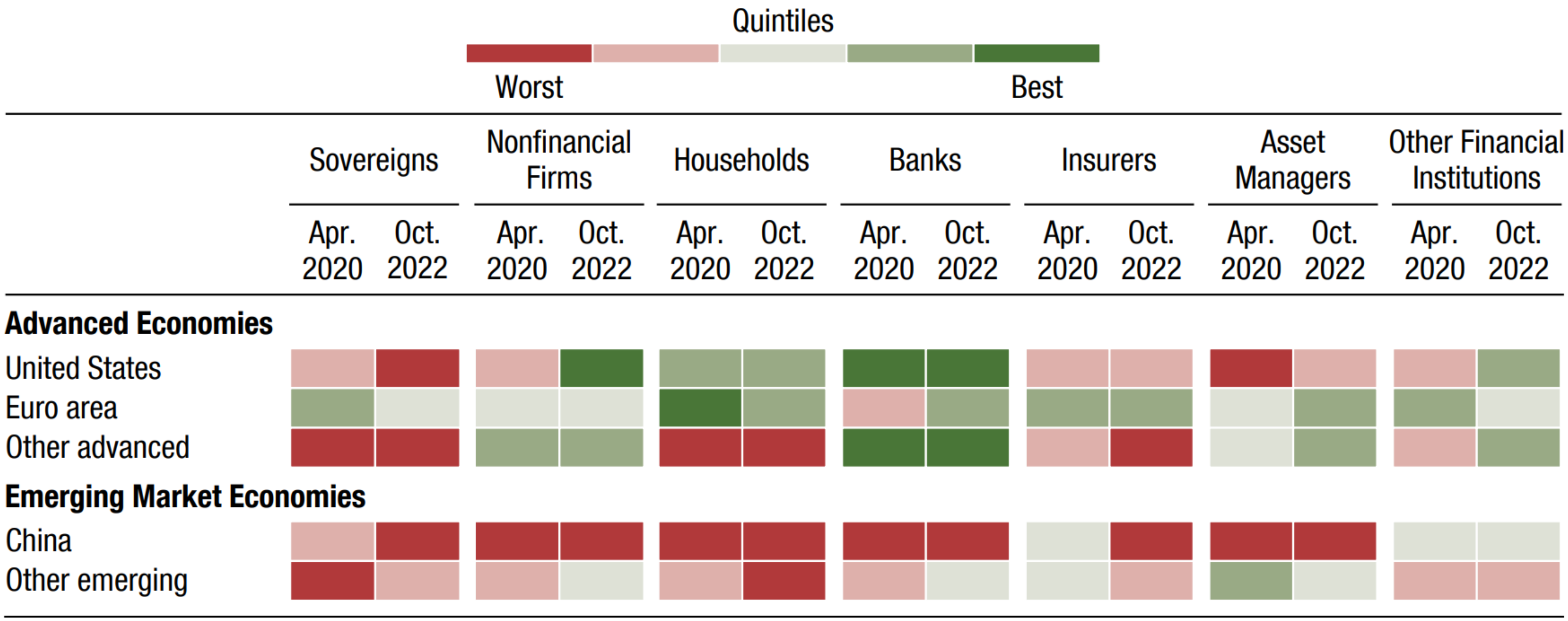
2 The global economy: key features

3 An overview of the regulatory agenda

4 The reinforced role of supervision: priorities

Global Financial Vulnerabilities

2. Financial Vulnerabilities by Sector and Region



Source: Global Financial Stability Report, Navigating the High-Inflation Environment, October 2022, IMF

1. FINANCIAL STABILITY: GLOBAL ASSESSMENT

Total credit to the non-financial sector (as a percentage of GDP)

	2007:Q4	2019:Q4	2022:Q1
Advanced economies	242.3	273.7	281.4
USA	229.9	255.1	274.8
UK	219.6	263.6	271.1
Euro Area	219.4	258.1	272.6
Japan	302.3	381.4	424.6
Emerging economies	111.6	203.0	229.8
China	142.5	263.1	291.5

Total credit to the government sector (as a percentage of GDP)

	2007:Q4	2019:Q4	2022:Q1
Advanced economies	69.5	100.4	111.0
USA	57.7	99.9	117.9
UK	41.4	83.8	99.6
Euro Area	66.0	83.9	95.7
Japan	142.1	203.3	231.3
Emerging economies	30.9	53.7	66.6
China	29.3	57.6	73.4

Source: Bank for International Settlements, 2008:Q4 for emerging market economies

1. FINANCIAL STABILITY: GLOBAL ASSESSMENT

Total credit to households (as a percentage of GDP)

	2007:Q4	2019:Q4	2022:Q1
Advanced economies	82.8	73.6	74.3
USA	99.1	75.3	77.2
UK	93.8	83.8	84.9
Euro Area	59.7	57.4	59.4
Japan	98.8	102.0	117.4
Emerging economies	22.0	45.7	50.7
China	18.9	55.5	61.4

Total credit to non-financial corporations (as a percentage of GDP)

	2007:Q4	2019:Q4	2022:Q1
Advanced economies	88.0	91.1	92.7
USA	70.0	76.2	80.6
UK	81.8	71.0	67.9
Euro Area	92.8	104.3	110.0
Japan	98.8	102.0	117.4
Emerging economies	58.7	103.4	112.6
China	94.3	150.0	156.7

Source: Bank for International Settlements, 2008:Q4 for emerging market economies

Some facts on high indebtedness

Private credit booms culminate many times in either economic underperformance or financial crisis…

Public debt booms are also associated with financial crisis, more frequently so in EMDEs…

Fiscal space matters, as higher levels of public debt are associated with longer periods of economic underperformance and larger costs of financial crisis…

Total (public and private) indebtedness tend to increase sizably in the aftermath of global recessions…

Financial crisis recessions are costlier than normal recessions in terms of lost output…

High debt is a drag on growth…

Source: “Stylised facts on debt and financial crisis”, Pedro Duarte Neves, SUERF Policy Note, Issue No 274, April 2022.

2. THE GLOBAL ECONOMY: KEY FEATURES

- Inflation (40 year high), Unemployment (40-50 year low), Debt (all time high)
- Tightening of financial conditions
- Subdued economic prospects
- Emerging markets: reduced policy space and tight conditions
- China: housing, construction, banking sector
- Corporate sector and leveraged finance
- Housing markets
- Banking sector, non-banking sector and interactions

Source: Global Financial Stability Report, IMF, October 2022

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FSB Work Program for 2022

1. Supporting international coordination on current financial stability initiatives
2. Enhancing the resilience of the non-bank financial intermediation sector
3. Enhancing cross-border payments
4. Harnessing the benefits of digital innovation while containing its risks
5. Addressing financial risks from climate change
6. Cyber and operational resilience
7. Enhancing central counterparty (CCP) resilience, recovery and resolvability
8. Completing resolution reforms

Source: FSB Work Programme for 2022, 31 March 2022; FSB Chair's letter to G20 Finance Ministers and Central Bank Governors

3. AN OVERVIEW OF THE REGULATORY AGENDA

- Implement the Basel III Finalization
- Develop a macro-prudential framework for non-banks
- Increase macro-prudential ‘space’ in banking
- Address insurance protection gaps
- Climate change: reinforce coordination on policies

Implement the Basel III Finalization

- Aim: to restore credibility in the measurement of solvency by curbing unwarranted variation in the calculation of risk-weighted assets

  through enhancing the robustness and risk sensitivity of the standardized method…

  through further limiting the use of internal bank models…

  through the use of a multi-metrics approach to capital measurement…

- The Basel III Finalization

  brings a coherent set of global standards, increasing level playing field at global level…

  the long-term benefits of the reform (through a reduction in both the tail risk and the intensity of a future banking crisis) are sizable and outweigh the transitory costs…

  brings a more robust approach to capital measurement…

Implement the Basel III Finalization

CAPITAL METRICS (Pros and Cons)

	Risk-weighted Capital Measures	Output Floor	Leverage ratio
Considers risk of individual assets	✓✓	✓✓	××
Mitigates risk for excessive risk-taking	✓✓	✓✓	××
Promotes risk management practices	✓✓	✓✓	××
Simplicity (versus complexity)	××	××	✓✓
Treatment of zero RWAs	××	××	✓✓
Model risk	××	××	✓✓
Pro-cyclicality	××	××	✓✓
Risk of building-up of excessive leverage	××	×	✓✓
Risks of gaming (non comparability)	××	×	✓✓
Lack of market confidence in RWAs	××	×	✓✓
RWAs dispersion and inconsistency	××	✓✓	×
Low levels of model based RWAs	××	✓✓	×
Horizontal inequality in RWAs requirements	××	✓✓	×

Legend: ✓✓ means *pros*; ×× means *cons*; × means mitigated *cons*.

Source: Neves, P.D. (2021), "Why finalising Basel III is good for the European banking sector?", ECMI Policy Brief, June 2021

Develop a macro-prudential framework for non-banks

- Assets of non-bank financial institutions correspond to about half of the assets of the global financial system
- The risks of high leverage (leveraged loans) have been identified well before COVID-19
- The non-banking sector remains largely unregulated

What is it needed?

to contain excessive leverage, excessive liquidity mismatches, and excessive pro-cyclicality…

to achieve a closer alignment between funds' redemption profiles and the underlying assets…

to increase the transparency and predictability of margining practices…

Action required:

develop macro-prudential framework for non-banks…

develop macro-prudential framework for insurers and pension funds…

Increase macro-prudential ‘space’ in banking

- The BCBS finds evidence of a positive relationship between capital headroom and lending
- The Covid-19 episode has shown some reluctance by banks to reduce capital buffers vis-à-vis regulatory requirements
- The Covid-19 episode has also shown that macro-prudential authorities with positive counter-cyclical capital buffers (CCyB) released them during the pandemic
- The BCBS has just communicated that sees benefits in a positive cycle-neutral CCyB

Source: Newsletter on positive cycle-neutral countercyclical capital buffer rates, BCBS, 5 October 2022

Address insurance protection gaps

- Insurance Protection Gaps are not a new issue (Geneva Paper 2014)
- COVID-19 has exacerbated some of them and brought new ones
- Protection gaps: **Pension, Natural Cathastrophe, Health, Cyber, Business interruption**

Why do we need to reduce insurance protection gaps?

- Reduction of insurance gaps brings more resilience to our societies
- Addressing insurance gaps contributes to stronger and more sustainable growth prospects
- Closing insurance protection gaps will make the societies more inclusive

BUT ONE SIZE DOES NOT FIT ALL!

Climate change: reinforce coordination on policies

- Need to progress in climate-related disclosures
- Need to overcome data gaps
- How to reflect climate-related risks into the micro and macro-prudential frameworks
- Advantage of a common regulatory approach to capital requirements
- [Avoid fragmentation of climate risk regulation and supervision]

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4 THE REINFORCED ROLE OF SUPERVISION: PRIORITIES

Figure 1

Supervisory priorities for 2022-2024 addressing identified vulnerabilities in banks

Priority 1 — Banks emerge from the pandemic healthy

Credit risk
- Deficiencies in **credit risk management frameworks**
- Exposures to **COVID-19 vulnerable sectors**, including **commercial real estate**
- Exposures to **leveraged finance**

Market risk and IRRBB
- Sensitivities to **shocks in interest rates and credit spreads**

Priority 2 — Structural weaknesses are addressed via effective digitalisation strategies and enhanced governance

Business model
- Deficiencies in banks' **digital transformation strategies**

Governance
- Deficiencies in **management bodies' steering capabilities**

Priority 3 — Emerging risks are tackled

Climate and environmental risk
- Exposure to **climate-related and environmental risks**

Market risk and credit risk
- Exposures to **counterparty credit risk**, especially towards non-bank financial institutions

Operational risk
- Deficiencies in **IT outsourcing** and **cyber resilience**

Source: ECB.

Notes: The figure shows the three supervisory priorities and the corresponding vulnerabilities to be addressed over the coming years through targeted activities by ECB Banking Supervision. Each vulnerability is associated with its overarching risk category. Supervisory activities addressing potential shocks to interest rates/credit spreads and exposures to counterparty credit risk should not be seen in isolation. They will complement and inform each other with a view to addressing broader financial market correction concerns.

Source: ECB Banking Supervision: SSM Supervisory Priorities for 2022-2024

4 THE REINFORCED ROLE OF SUPERVISION: PRIORITIES

- System-wide approach to stress testing
- Approach to climate change risks
- Supervisory approach to digitalisation
- Conduct supervision

System-wide approach to stress testing

- Favor top-down stress tests and fully ownership of the exercise by the supervisor
- Favor the use of dynamic balance sheets
- Favor a system-wide approach covering banks, insurers, pension funds, and the asset management industry
- Include contagion and amplification effects between banking and non-banking
- Progress on granularity of information
- Reinforce the holistic approach to capital assessment
- Reinforce forward-looking analytical tools [business model assessment]

Approach to climate change risks

- Definition of supervisory expectations: on business model and strategy, governance and risk appetite, risk management, and disclosures
- Stress testing and scenario analysis: bottom-up and top-down
- Need to develop a comprehensive, strategic and forward-looking approach to manage C&E risks [transition plans closely linked to business plans]
- Incorporation of C&E risks in the SREP
- [Avoid fragmentation of climate risk supervision]

Supervisory approach to digitalisation

- Right balance between the benefits of innovation/competition and the risks of damaging consumers' interests
- Right balance between enabling financial innovation and safeguarding financial stability/integrity
- Assess business model sustainability of new players
- Outsorcing
- Cybersecurity [cybersecurity protection gap]
- Benefits and risks of BIGTECH in finance
- RegTech and SupTech

Conduct supervision

- Reinforce conduct supervision and enforcement
- Reinforce monitoring of costs and past performance of financial products
- A simpler approach to consumer disclosures [fit for the digital age]
- Reinforce AML/CFT supervision and enforcement
- Address mis-selling and detrimental practices for consumers
- Address model sustainability of innovative new players
- Promote digital responsibility: fairness, non-discrimination, transparency, explainability, resilience, security of data
- The importance of financial literacy [and the learnings from behavioral economics]

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