

Finance Watch response to the European Commission's Targeted consultation on Improving the EU Macprudential Framework for the Banking Sector

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Finance Watch is an independent, non-profit public interest association dedicated to making finance work for society. It was created in June 2011 to be a citizens' counterweight to the lobbying of the financial industry and conducts technical and policy advocacy in favour of financial regulations that will make finance serve society.

Its 70+ civil society members from around Europe include consumer groups, trade unions, housing associations, financial experts, foundations, think tanks, environmental and other NGOs. To see a full list of members, please visit www.finance-watch.org.

Finance Watch was founded on the following principles: finance is essential for society and should serve the economy, it should not be conducted to the detriment of society, capital should be brought to productive use, the transfer of credit risk to society is unacceptable, and markets should be fair and transparent.

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Summary

There is only limited evidence of the overall effectiveness of the current buffer framework since it was put in place in 2014, as this was a period of generally benign economic conditions, stopped short only by the Covid-19 pandemic. As of the beginning of 2020, only five of the European member states had appropriate countercyclical (CCyB) buffers in place. Thus, releasable buffer capacity to cushion the effects of the economic shock was very limited.

On present evidence, Finance Watch is of the view that the current macroprudential framework suffers, first and foremost, from the inconsistency of its application by the member states. This relates to the use of the CCyB and systemic risk buffers (SyRB) and can also be observed in member states' approach to the designation of other systemically important institutions (O-SIIs) and the use of O-SII buffers.

Finance Watch cautions against using macroprudential instruments to compensate, usually ex-post, for the inadequate calibration of microprudential requirements. Financial stability considerations should not be sacrificed to achieve political objectives such as avoiding 'unduly raising capital requirements'. Further, the current macroprudential framework lacks tools to address climate-related systemic risk, which has been recognised as one of the major risks to the financial system.

Finance Watch therefore recommends:

- Clarification of the distinction between structural and cyclical buffers; the latter should be considered as a 'first line of defence' in any economic downturn.
- Introduction of a mandatory CCyB, with a target rate in the range of 3-4% of RWA to be accrued over a 5-year period. The number corresponds broadly to the average level of management buffers held by Euro-area banks.
- Alignment of the designation scheme for O-SIIs with the criteria for determining 'significant institutions' under the Single Supervisory Mechanism (SSM), in particular the total assets threshold of EUR 30 bn.
- Empowering national supervisory authorities to impose mandatory restrictions on dividend distributions, share buy-backs and variable remuneration payments in crisis times.
- Development of dedicated macroprudential tools to address climate-related systemic risks to the banking sector.
- Faithful implementation of the Basel III reforms at the EU level, in particular, the risk weights for property-backed and corporate exposures; dilutive 'transitional arrangements' that could lead to permanent non-compliance with the agreed international framework should be avoided.

Question 1: Has the capital buffer framework been effective so far in providing sufficient resilience against all types of systemic risks in Member States and for different types of banks and exposures?

(1 = highly ineffective, 5 = highly effective)

1 **2** 3 4 5 Don't know/no opinion

Please explain your answer to question 1, considering not only overall resilience, but also the interactions of the individual components of the capital buffer framework (i.e. CCoB, CCyB, G-SII, O-SII and SyRB buffers); is it sufficiently clear which buffer is to be used to address which risk?

There is only limited evidence of the overall effectiveness of the buffer framework so far given that the period under consideration, since 2014, has been marked by a long period of generally benign economic conditions, stopped short only by the onset of the Covid-19 pandemic in 2020. Throughout that period, the use of the macroprudential instruments contained in CRR/CRD by member states authorities has been very inconsistent, even when allowing for the differences in the trajectory of growth and economic conditions at the national level: while some jurisdictions have been very proactive in addressing signs of economic imbalances and excessive credit growth others have been visibly reluctant to take action in a timely manner.

The performance of the macroprudential framework in the context of the Covid-19 emergency should be evaluated with caution. In addition to the release of macroprudential buffers, credit institutions benefited from a wide range of other microprudential capital relief measures. More importantly, however, massive fiscal intervention, including public guarantee schemes and direct support to borrowers, played a decisive in cushioning the immediate impact of the crisis. The medium-term effects of the crisis, in the shape of a lasting deterioration in asset quality, will only become apparent in due course. We do agree, however, with the Commission's observation that the banking sector did not have adequate countercyclical buffer (CCyB) capacity going into the crisis. At the end of 2019, at the end of a six-year growth cycle, only five member states had a positive CCyB in place.

On present evidence, Finance Watch is of the view that the current macroprudential framework suffers, first and foremost, from the inconsistency of its application by the member states. This relates primarily to the use of the countercyclical and systemic risk (SyRB) buffers but can also be observed in member states' approach to the designation of other systemically important institutions (O-SIIs) and the use of O-SII (O-SIIB) buffers. In 2017, when two regional banks, Veneto Banca and Banca Popolare di Vicenza, were liquidated, state aid of up to EUR 4.8 bn was granted by the member state, and approved by the Commission, on the grounds that these entities were of systemic importance. Neither of them was a designated 'O-SII', however. This case demonstrates how failure by the relevant authorities to apply the O-SII framework in a consistent manner ultimately becomes very costly for member-state taxpayers – and poses a latent risk for financial stability.

The Capital Conservation Buffer (CCoB) is, in our view, one element of the Combined Buffer Requirement (CBR) that has so far fulfilled its objective, which is to increase banks' resilience at the individual level and financial stability overall. According to EBC data, the CCoB provided by far the largest contribution to the aggregate CBR of Euro-area banks at the onset of the Covid-19 emergency [Behn, Rancoita &

Rodriguez d'Acari, 2020]. The role of the CCoB as the most significant, and most stable element of the macroprudential framework appears to be closely linked to the fact that the CCoB is compulsory for virtually all EU banks, with only very limited scope for national discretion. The fact that the CCoB does not lend itself as readily to being released in a downturn should not be seen as a problem. By design, structural buffers, such as the CCoB and the G-/O-SIIB, act as a 'second line of defence'. They should be considered as complementary to, not as substitutes for cyclical buffers, such as the CCyB and the SyRB, and be released only after the latter have been exhausted.

Question 2: Has the capital buffer framework been effective in dampening financial or economic cycles in Member States?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 2, considering in particular the experience to date with the calibration of buffers during phases of economic growth and rising vulnerabilities, and the use of buffers after an economic/financial shock; do you see any impediments to the intended use of buffers both during upswing and downswing phases?

Finance Watch agrees with the Commission's observation that the scope for releasing capital buffers in response to the Covid-19 crisis from macroprudential buffers was very limited. Before considering improvements in its design we would, however, first draw attention to the actual use, or lack of, of the existing buffer framework. In our view, the observed lack of releasable buffer capacity is attributable primarily to the obvious reluctance of the relevant authorities to implement appropriate buffers, specifically the CCyB, during the upcycle. In Q2 2019, at the peak of a six-year period of strong economic growth, positive CCyB rates were in place in only five of twenty-seven member states. As a result, total available CCyB amounted to only 0.1% of risk-weighted assets in the Euro area at the outset of the Covid-19 pandemic, according to a study by the ECB [Behn, Rancoita & Rodriguez d'Acari, 2020].

A similar reluctance has been in evidence with respect to emerging sectoral risks. By the end of 2019, the ESRB had issued recommendations to six, and warnings to three member states on medium-term vulnerabilities in the residential real estate sector. By the time the Covid-19 emergency struck only four of these nine jurisdictions had appropriate macroprudential buffers (CCyB or SyRB) in place. The outbreak of the Covid-19 pandemic in 2020 and the related crisis have not led to a cyclical decline in housing markets. In its recent recommendations to two member states [ESRB/2021/10 and ESRB/2021/11], the ESRB notes that *"real house price and lending growth have accelerated further in several countries, largely outpacing the growth in household income"*. The ESRB goes on to observe that, given the increasing vulnerabilities, the actions adopted by some of the countries so far were not considered sufficient.

Finance Watch believes that an effective macroprudential framework should protect citizens and the economy at large against the impact of both cyclical downturns and severe one-off economic shocks, which should be considered as additive layers. It stands to reason that cyclical buffers must be accrued

during the economic upturn so that they can be released during the downturn. We would therefore propose the introduction of a mandatory CCyB, with a target rate in the range of 3-4% of RWA, which would correspond broadly to the average level of management buffers held by Euro-area banks. The CCyB could be accrued, initially, over a 5-year period, which is broadly in line with a typical economic upcycle. It should be set at the member-state level and triggered by a simple economic indicator (e.g. two consecutive quarters of GDP growth exceeding a given minimum level), with relevant authorities required to (a) notify the ESRB as soon as the trigger condition has been met, and (b) instruct the institutions under their purview to build up, or replenish their CCyB towards the target level. Banks would be required to submit CCyB accrual/replenishment plans, which take into account their individual starting conditions. Relevant authorities could be granted the right to postpone the CCyB accrual phase if there is reasonable doubt about the sustainability of the upturn. Such a postponement would have to be notified to, and approved by the ESRB. In the event of a downturn, relevant authorities should be entitled to authorise the release of CCyB either (a) on the basis of a suitable economic indicator (e.g. a decline in GDP growth exceeding a certain threshold level) or (b) at the recommendation of the ESRB. The ESRB should be mandated with monitoring and co-ordinating the implementation of this arrangement, while the EBA should monitor and supervise its enforcement.

We note that macroprudential instruments should not be mistaken as a way to compensating, usually ex-post, for the inadequate calibration of microprudential requirements. This is why Finance Watch has called upon the co-legislators currently discussing the 2021 Banking Package to implement, in particular, the risk weights for property-backed and corporate exposures in line with the Basel III standards and to refrain from introducing dilutive 'transitional arrangements' that could lead to permanent non-compliance with the agreed international framework. If the microprudential framework is expected to fulfil its stated purpose, which is to guide the efficient allocation of capital according to risk, it is critical that decisions about the sectoral allocation of capital, which are made at the level of the individual institution, are regulated at that level before sectoral imbalances are allowed to emerge at the level of the economy at large. We would argue, therefore, that excessive credit growth, e.g. in the property sector, should preferably be dealt with at the microprudential level, with sectoral macroprudential tools – including the SyRB and measures under Art. 458 CRR – acting as a potential 'fallback' only. A similar logic applies to the use of P2R and P2G to cover model risk, i.e. the risk that the use of internal models could result in the under-reporting of risk-weighted assets (RWA) and hence an underestimation of capital requirements. Model risk is a typically idiosyncratic risk and should be reflected in Pillar 2 unless, and only if the potential capital shortfall has been adequately compensated by the Basel III 'output floor'. It is all the more important, therefore, that the EU implements the 'output floor' in full and without dilution.

Question 3: How well is the systemic importance of banks addressed by G-SII and O-SII capital buffer requirements?

(1 = very poorly, 5 = very well)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 3, considering in particular whether G-SII and O-SII buffer requirements are appropriate and coherent, also across countries, in view of their market shares,

activities, market conditions, advances in setting up the Banking Union, and the risk their failure would pose to financial stability.

The G-SII framework is largely aligned with international standards and the recommendations of the Financial Stability Board (FSB) and the Basel Committee (BCBS). While Finance Watch sees further room for improvement of the G-SII framework at the global level we are conscious that these matters are outside of the immediate scope of this consultation. We note, however, that the current list of G-SIIs, as compiled by the FSB, is too restrictive and does not realistically reflect the complete population of all international banking groups that pose a systemic risk to the global economy. One aspect, which is especially pertinent to Europe, is the assumption that some globally active groups should not be considered as systemically important at the global level because, among other arguments, their regional operations are expected to be separately resolvable in the event of a crisis (Multiple Point-of-Entry, MPE resolution). The MPE approach has never been tested in practice and it remains very doubtful whether it can actually be implemented in an emergency.

In the context of this consultation, Finance Watch would like to voice its concern about the obvious lack of effectiveness and consistency of the O-SII framework in the EU (see Q.1), whose shortcomings stand out in particular contrast to the relative homogeneity of the Single Supervisory Mechanism (SSM). We are mindful of the specific legal preconditions of the SSM and of the complexity of achieving regulatory convergence in regulating the banking sector in and outside of the Euro-area. We still see little reason, however, for the current parallelism of the O-SII designation process under the Capital Requirements Directive (CRD V) and the approach towards designating 'significant institutions' under the SSM Regulation (SSMR). The latter provides for the inclusion of the three largest institutions in each Euro-area member state and sets a minimum size threshold of EUR 30 bn. These criteria are much more reflective of the realities of systemic importance in the EU, especially in smaller jurisdictions and at the regional level (as illustrated, for instance, by the case of Veneto Banca and Banca Popolare di Vicenza - see Q.1). We would therefore recommend that the designation scheme for 'significant institutions' should be expanded and applied to the determination of 'O-SII' in general. In particular, the 'O-SII' designation should become mandatory for all institutions with consolidated assets exceeding the threshold of EUR 30 bn and waivers should be granted by competent authorities only in exceptional cases ('comply or explain') and subject to review by the ESRB. This would greatly enhance regulatory convergence and contribute to the alignment between Euro-area and non-Euro-area jurisdictions.

1.2. POSSIBLE IMPROVEMENTS OF THE BUFFER FRAMEWORK

Question 4: What changes would improve the current buffer framework and what would be, in your view, the pros and cons of these changes?

Question 4.1. Enhanced clarity of the buffer framework: Consider whether there is scope for simplifying/streamlining the buffer framework or providing better guidance on how to use it.

Finance Watch would recommend, in particular, a clearer distinction between structural and cyclical buffers. Cyclical buffers, such as the CCyB and SyRB, should be considered as a 'first line of defence' in any economic downturn. They should be built up and replenished, on a mandatory basis, during the economic upcycle and should be easy to release in a downturn, if required (see Q.2). A sizable, mandatory CCyB could take on the role currently fulfilled by management buffers, except that this

arrangement would be (a) obligatory for institutions and (b) transparent for market participants. This approach would improve market participants' ability to assess the capital position and resilience of a bank throughout the economic cycle and could go a long way towards addressing the question of 'stigma' (see Q.7) without necessarily leading to a significant increase in capital requirements.

We would warn against seeking trade-offs between structural and cyclical buffers, in particular between the CCoB and CyCB. As mentioned previously (see Q.1) they serve different purposes and should not be considered exchangeable. The CCoB and G-/O-SIIB should be seen as a 'second line of defence' to be activated only in the event of a severe systemic crisis after cyclical buffers have been depleted.

Question 4.2. Releasable buffers: Consider in particular whether an increase of releasable buffers could be achieved in a capital-neutral way over the cycle, the circumstances and conditions under which buffers should be released and what coordination/governance arrangements should be in place.

(see Q.2)

Question 4.3. Buffer management after a capital depletion: How can capital buffers be restored/replenished after an adverse shock in such a way that banks will provide sufficient lending in the recovery? In that regard, is there scope for optimising the MDA restrictions and capital conservation rules as laid down in Articles 141 to 142 CRD?

If the CCyB is enhanced in the proposed way (see Q.2) it would not be necessary, in our view, to automatically impose restrictions on distributions when cyclical buffers (SyRB, CCyB) get depleted in a downturn. Following the logic of a sequential depletion of buffers, starting with the cyclical ones (SyRB and CCyB, in that sequence), we would argue that an infringement of cyclical buffers could be exempted from automatically triggering restrictions. Relevant authorities should be empowered, nevertheless, to impose restrictions in response to a breach of the cyclical buffers, e.g. if they conclude that such a breach is not justified by macroprudential considerations and attributable mainly to problems at the level of the individual bank. Infringements of structural buffers, i.e. the G-/O-SIIB and CCoB, continue to automatically trigger the requirement to calculate the MDA and apply restrictions, if necessary, as per the current framework.

Question 4.4. Overlap between capital buffers and minimum requirements: How important is it to reduce the overlap between capital buffers and other requirements, and how could this be achieved without unduly raising overall capital requirements and having to re-open the composition of the leverage-ratio based "capital stack" and the calibration of the MREL based on the total exposure measure and the MREL subordination requirement?

Finance Watch would like to caution against blurring the boundaries between (microprudential) minimum requirements and the macroprudential buffer framework. As mentioned previously (see Q.2) micro- and macroprudential regulation pursues different and complementary objectives. Microprudential minimum requirements, including Pillar 2 Requirements (P2R) and Guidance (P2G) should therefore accurately reflect, and safeguard against the idiosyncratic risk of the institution and its business while the (macroprudential) CBR are designed to cover its contribution to systemic risk. The same applies, mutatis mutandis, to the minimum requirement for own funds and eligible liabilities (MREL), which again serves

an altogether different purpose, which is to facilitate recovery and resolution. There are, in our understanding, only limited areas of structural overlap (see Q.2). From the perspective of financial stability, it is essential to apply each of these frameworks on its own merits to ensure that institutions are capitalised in accordance with their actual risk profile.

Finance Watch is very critical, in particular, of the stated objective to avoid ‘unduly raising capital requirements’. At present there is little evidence to suggest that EU banks are exceedingly well capitalised: as of June 2021, the leverage ratios of major European banking groups continued to be lower (5.3%) as compared to their American (5.9%) and other global peers (7.2%). In other words, the capital ratios of major European banks were between 10% and 25% lower than their global peers’. We believe that any discussion regarding design of the prudential framework for banks should be concerned, first and foremost, with preserving financial stability, protecting the interest of the general public and controlling the risk of ‘moral hazard’. If the capitalisation of EU banks is found wanting, as it may well be, it is the responsibility of legislators and regulators to set appropriate, if necessary higher, requirements.

Question 4.5. Consistent treatment of G-SIIs and O-SIIs within and across countries: Should there be more EU-level guidance or binding rules on the identification of O-SIIs and the calibration of O-SII buffers? Should the leverage ratio buffer requirement for G-SIIs also apply to O-SIIs?

Question 4.6. Application of the SyRB to sectoral exposures: Are the thresholds for opinions and authorisations appropriate for sectoral SyRB rates (and for the sum of G/O-SII and SyRB rates)? Should the combined SyRB rate be calculated as a percentage of total risk exposure amounts and not sectoral risk exposure amounts? How should sectoral risk exposure amounts be calculated after the introduction of the output floor?

Question 5: Based on the experience so far, have you observed any major gaps in the EU macroprudential toolkit (also beyond the buffer framework)?

(1 = major gaps, 5 = fully comprehensive)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 5, indicating which gaps you perceived and what consequences these gaps have or might have had.

Question 6: Has the experience with the macroprudential toolkit so far revealed any redundant instruments or instruments that need to be redesigned to make them fit for purpose?

Yes No Don't know / no opinion

Please explain your answer to question 6, specifying which instruments could be redundant or would need to be redesigned, as well as the expected benefits thereof:

Question 7: How effective has the macroprudential toolkit and EU governance framework been in managing a crisis?

(1 = highly ineffective, 5 = highly effective)

1 **2** 3 4 5 Don't know/no opinion

Please explain your answer to question 7, notably in light of the experience gained during the Covid-19 crisis:

(see Q.1)

Question 8: What changes to the current set of instruments would improve the macroprudential toolkit and what would be, in your view, the pros and cons of these changes?

Question 8.1. Borrower-based measures: Should all Member States have a common minimum set of borrower-based measures to target more directly potentially unsustainable borrowing by households and corporates, particularly in a low-interest-rate environment? Which tools should Member States have and what role should EU bodies play in fostering their effective use?

Finance Watch supports the introduction of a minimum set of borrower-based measures to address the problem of household indebtedness, in particular. These should include, in particular: maximum thresholds on Loan-to-Value (LTV) and Debt Service-to-Income (DSTI) ratios for property-backed lending. We are aware that other forms of lending, in particular consumer loans, may in some circumstances also contribute to the emergence of major economic imbalances. In recent years, several member states have implemented a variety of tools to address potential risks in this area. To assess these risks on a comprehensive basis, and to identify a consistent and effective set of EU-wide instruments, we would suggest to mandate the ESAs to issue a joint report and recommendations, which could inform subsequent legislation.

Question 8.2. System-wide distributions restrictions: Should EU and/or national authorities have the power to restrict distributions for the entire banking system to conserve capital in a severe crisis situation? Under which conditions and how should such system-wide restrictions be used, taking also into account the role of European bodies?

A significant body of research, including studies and recent reports by the BIS [Basel III Monitoring Report, 2022] underlines the important role of retained earnings in building up and conserving capital. Especially in a crisis, a bank may have incentives to make distributions, e.g. to shore up its share price or prevent a rating downgrade, even if its capital position is precarious and may be further eroded as a result. A relevant study by the BIS [Acharya, Le and Shin, 2016], demonstrates that dividend payouts by one bank exert negative externalities on the other banks' equity. Because individual banks do not internalize these negative externalities, their uncoordinated dividend policies can be excessive, even to the detriment of their own shareholders' collective interests. Conversely, greater retention of earnings as equity exerts positive spillover effects on other banks, resulting in higher value of the financial sector as a whole.

Another study by the BIS [Gambacorta, Oliviero and Shin, 2020] demonstrates that the incentive for banks to distribute dividends is greater when the price-to-book ratio falls, especially below one, a situation that applies to many banks in the Euro area at present. The study further shows that if banks were not to distribute dividends but to accumulate them in their capital base, there would have been substantial positive effects on lending. According to that study, bank lending capacity over the period 2008–20, would have been around 9% greater, which corresponds to roughly 11.2–15.5% of the GDP of the 30 advanced economies considered in this study. These findings corroborate the view, which is also shared by Finance Watch, that a stronger capital base tends to be conducive, rather than an impediment to bank lending.

Finance Watch suggests that relevant authorities should be legally empowered to require financial institutions under their remit to refrain from making dividend distributions, buying back ordinary shares, or paying variable remuneration to a material risk taker, which has the effect of reducing the quantity or quality of own funds at the EU group level and, where appropriate, at the sub-consolidated or individual level. We would agree with the authors of the ECB's recent Macroprudential Bulletin [Katsigianni et al., 2021] that the application of restrictions on distributions should be decided by the banking group's home authorities at the highest level of consolidation. This approach would be consistent with the principle of free movement of capital within the EU and avoid ring-fencing along national lines. The ESRB should continue to issue recommendations, while EBA should be tasked with monitoring and coordinating the implementation of recommended restrictions by the relevant authorities.

Question 8.3. Temporary relaxation of prudential requirements to support the recovery after a shock: Should EU and/or national authorities have more powers to relax prudential requirements after banks have suffered a shock, to avoid pro-cyclical behaviour and enhance banks' capacity to support the recovery? What elements of the prudential framework could be addressed using such powers (e.g. unwarranted risk weight hikes after a shock)? Could Art. 459 CRR be adapted for this purpose?

We oppose the concept of relaxing (micro)prudential minimum requirements following a shock. This approach blurs the boundaries between the micro- and macroprudential frameworks, which this review is meant to strengthen. Minimum microprudential requirements are, first and foremost, meant to shield the general public from the idiosyncratic risks of a particular institution and to ensure that investors have sufficient 'skin in the game' to impose an adequate level of market discipline on the institution its management (see Q.2 and Q.4.4).

Question 8.4 Instruments targeting risk weights and internal model parameters: How will the forthcoming application of the input and output floors under the Basel III agreements affect the need for tools that adjust risk weights or the parameters of internal models (Art. 124, 164 and 458 CRR)? Are such tools still necessary and, if yes, how should they be adapted to the new regulatory environment?

Question 9: Are macroprudential measures as used by national authorities generally commensurate with systemic risks in a given country, or do you consider that there are unjustified disparities across countries?

(1 = highly disparate, 5 = fully commensurate)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 9, providing supportive evidence on possible disparities and their likely impact on the internal market:

(see Q.1)

Question 10: Has the oversight of national macroprudential policies through notification, assessment and authorisation procedures been proportionate and effective in preventing an excessive use of macroprudential tools and undue market fragmentation?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 10, taking also into account the complexity of procedures and related administrative burdens for authorities and the industry and whether you see scope for streamlining and simplifying the procedures, while retaining necessary safeguards:

(see Q.1)

Question 11: Have the provisions on reciprocity been effective in maintaining a level playing field in the banking sector and preventing the circumvention of national macroprudential measures through regulatory arbitrage?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 11, indicating notably whether you would see merit in extending the mandatory reciprocity framework to the instruments not currently covered by it:

Question 12: Has the current allocation of responsibilities for macroprudential policy between the national and European level been effective in ensuring that sufficient and appropriate action is taken to limit systemic risks and manage crises?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 12, taking notably into account the roles of the ESRB, the ECB and the Commission (which may impose stricter prudential requirements in accordance with Article 459):

(see Q.1)

Question 13: What changes to the current governance arrangements and oversight procedures would improve the compatibility of macroprudential policy making with the internal market, and how could the complexity of procedures be reduced?

Question 13.2 Monitoring of the macroprudential stance: Should there be regular overall assessments of the macroprudential requirements (or stance) in each Member State in addition to, or as a substitute of, the EU-level monitoring and vetting of individual macroprudential measures? What measures should be available to which bodies in case the national macroprudential stance is deemed disproportionate to the level of risk (too low or too high)?

Question 13.2 Reciprocation of national macroprudential measures: Should there be mandatory reciprocation for a wider range of macroprudential measures and how could this be implemented (role of the ESRB, materiality thresholds, etc.)?

Question 14: Have macroprudential tools been appropriate and sufficient to limit the systemic risk arising from EU banks' exposures to third countries?

(1 = not at all appropriate and sufficient, 5 = fully appropriate and sufficient)

1 2 3 4 5 **Don't know/no opinion**

Please explain your answer to question 14, also in light of the experience gathered so far, considering in particular whether the EU's existing macroprudential tools and capital requirements (notably Articles 138 and 139 CRD) are sufficient to limit systemic risks emanating from EU banks' third country exposures:

Question 15: Is the EU macroprudential toolkit adequate for monitoring and mitigating banks' systemic risks related to global market-based finance, securities and derivatives trading as well as exposures to other financial institutions?

(1 = not at all adequate, 5 = fully adequate)

1 2 3 4 5 **Don't know/no opinion**

Please explain your answer to question 15 in light of the experience gathered so far, identifying in particular gaps related to derivatives, margin debt and securities financing transactions:

4.2. POSSIBLE ENHANCEMENTS OF THE CAPACITY OF THE MACROPRUDENTIAL FRAMEWORK TO RESPOND TO NEW GLOBAL CHALLENGES

Question 16: How do you expect systemic risks to evolve over the coming years and what enhancements of the EU macroprudential monitoring framework and toolkit (notably capital buffers, rules on risk weights and exposure limits), would be necessary to address global threats to financial stability?

Question 16.1. Financial innovation: What risks to financial stability could result from banks' new competitors (FinTech and BigTech) and the arrival of new products (notably crypto-based)? Is there a need to enhance banks' resilience in view of such changes? If so, how could this be achieved while maintaining a level playing field?

Question 16.2. Cybersecurity: Is there a need to enhance the macroprudential framework to deal with systemic cybersecurity threats? If not, how should the existing tools be used to mitigate threats and/or build resilience?

Question 16.3 Climate risks: Should the macroprudential toolkit evolve to ensure its effectiveness in limiting systemic risks arising from climate transition and from physical climate change, also considering the current degree of methodological and data uncertainty? And if so, how?

We strongly support the introduction of a **dedicated macroprudential tool** to mitigate/limit climate-related systemic risks based on the following considerations:

1) Despite the recognition of the systemic dimension of climate-related financial risks (CRFR), the existing macro-, as well as micro-, prudential frameworks in their current design do not offer sufficient room to address these risks. In its legislative proposal for the CRD review, the Commission stated that the "provisions in Article 133 on the systemic risk buffer (SyRB) framework may already be used to address various kinds of systemic risks, which may include risks related to climate change". However, by the CRD definition, the current SyRB targets the risks of disruption in a specific Member State (MS) and is deployed by national competent authorities (NCAs). Considering the current degree of methodological and data uncertainty and lack of sufficient expertise, it is unlikely that the NCAs will be able to address CRFR in a credible and consistent manner. The necessity of consistent approach across MS is of particular importance in the case of CRFR, as the disruptions they will cause are not limited to national or regional economies. There have been no precedents of using SyRB to address CRFR.

2) Macroprudential tools are generally well suited to address financial stability dimension of CRFR:

- **The tools are pre-emptive in their nature.** They have been deployed to counteract the build-up of risks in the financial system (structural or cyclical), which is particularly essential in the case of CRFR, which are forward-looking by nature.
- **The tools are able to account for a longer time horizon of risk materialisation** and, by this, overcome conceptual limitations of the existing microprudential framework, which is largely reliant on a one- to three-year time horizon for the management of risks. For example, the countercyclical buffer clearly takes a multi-year through-the-cycle perspective to pro-cyclical risk components.

- **CRFR clearly fit into the context of the defined intermediate objectives of the EU macroprudential framework.**[1] Specifically, mitigating CRFR should be done with the objectives of: i) limiting excessive credit growth and risk concentrations in the sectors, which will be primarily impacted by climate transition risk AND which are not demonstrating sufficient progress to mitigate that risk (i.e. embark on transition); ii) tackling misaligned incentives of the financial sector, which helps accelerate climate change by financing activities at the core of climate change, which, in turn, increases systemic risk in the financial system. As recent research shows, banks' portfolios are currently significantly misaligned with the Paris agreement goals and the respective governments' climate commitments[2].

The role of macroprudential tools to increase banks' resilience to CRFR has been already discussed by the ECB[3] and BIS[4]. In our view, among different available types of tools, capital-based instruments (buffers) should be primarily considered, as capital is the major tool to ensure banks' resilience to systemic risk in the time where other prudential measures are still largely limited to exploratory efforts and have not resulted in real changes to the incentives for banks based on risk considerations.[5]

The existing data and methodological challenges in dealing with CRFR should not be a reason for inaction, as supervisors have clearly recognised the growing cost of such inaction for the financial system[6]. Macroprudential tools can be calibrated based on a combination of quantitative and qualitative considerations (which is also the practice in case of countercyclical buffer):

- The deviation of the global greenhouse gas emission volumes from their target levels to reach the Paris goals (measured as the remaining carbon budget) should serve as an indicator of systemic CRFR based on the fact that climate-related systemic risk will increase with rising global temperatures unless preventive measures are taken. This is due to the fact that large emission volumes imply either large transition risks short-term (in case of delayed and more abrupt transition) and/or large physical risks (in case the required transition does not happen).
- The individual institutions' buffer size should be made dependent on the amount of financing provided to the sectors highly exposed to CRFR such as fossil fuel financing, as these will be the major source of transition risk. However, the buffer should be non-zero also for the banks that do not provide such financing to account for the physical risk dimension.
- The minimum level of buffer should be applicable to all banks based on the indicator of systemic risk, as described above. This is essential to ensure the resilience of financial institutions as long as global climate goals are not met and the risk of financial losses resulting from extreme certain-to-arrive climate events with unpredictable impacts (so-called "green swans"[7]) remains.

References:

[1] ESRB, [Flagship Report on macro-prudential policy in the banking sector](#), March 2014.

[2] H. Miller, S. Dikau, [Preventing a 'climate Minsky moment'](#): environmental financial risks and prudential exposure limits Exploring the case study of the Bank of England's prudential regime, The Grantham Research Institute on Climate Change and the Environment, March 2022.

[3] ECB Macroprudential Bulletin, [The challenge of capturing climate risks in the banking regulatory framework: is there a need for a macroprudential response?](#), prepared by I. Baranović, I. Busies, W. Coussens, M. Grill and H. Hempell, October 2021.

[4] R. Coelho and F. Restoy, [The regulatory response to climate risks: some challenges](#), BIS Financial Stability Institute, FSI Brief No 16, February 2022.

[5] Finance Watch, A Silver Bullet Against Green Swans, November 2021.

[6] See for example, S. Alogoskoufis, N. Dunz et al, [ECB economy-wide climate stress test: Methodology and results](#), ECB Occasional Paper Series, No 281, September 2021.

[7] BIS, BdF – P. Bolton, M. Despres, L.A. Pereira da Silva, F. Samama, R. Svartzman, “The green swan: Central banking and financial stability in the age of climate change”, January 2020; NGFS First Comprehensive Report. A Call for Action - Climate Change as a Source of Financial Risk”, April 2019.

Question 16.4. Other ESG risks: Should the macroprudential toolkit further evolve to address financial stability risks stemming from unsustainable developments in the broader environmental, social and governance spheres? How could macroprudential tools be designed and used for this purpose?

Question 17: Do you have any general observations or specific observations on issues not covered in the previous sections?

With reference to our response to Question 16.3, we emphasise the necessity of an EU-wide (and also worldwide in a broader sense) approach to tackle climate-related financial risks. Therefore, any macroprudential tools introduced to address these risks, should be mandatory EU-wide and not be left to the discretion of the Member States. A possible solution could be assigning the competency to the ECB with close coordination/alignment with the ESRB, who would have the competency over climate risk buffers for the non-ECB supervised institutions in the Member States.

The suggested macroprudential buffer for climate risk (Climate Risk Buffer, CIRB) should be viewed as a dedicated tool rather than part of any of the existing buffers such as, in particular, the SyRB. The CIRB should be considered as a structural buffer (similar to the CCoB and O-/G-SIIB) due to the forward-looking and long-term nature of climate change and related climate risk developments, which is different from the cycle-dependent factors underlying CCyB and SRyB (e.g. property prices).