ESRB
European Systemic Risk Board
European System of Financial Supervision

Press release

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The General Board of the European Systemic Risk Board takes first set of actions to address the coronavirus emergency at its extraordinary meeting on 6 May 2020

At its extraordinary meeting on 6 May 2020, the General Board of the European Systemic Risk Board (ESRB) discussed a first set of actions in five priority areas identified to address the impact of the coronavirus (COVID-19) emergency on the financial system from a macroprudential perspective. These actions are guided by two overarching principles. First is to achieve an effective policy response across sectors and across countries, and, at the same time, ensure that necessary national macroprudential actions do not cause negative spillovers and negatively affect the EU's Single Market and the level playing field. The second principle is to make use of the flexibility provided within existing regulatory standards such as the capital relief for banks announced by European banking supervision[1]. This aims to enable financial institutions to continue providing vital financial services to the real economy, and to ensure that adequate capital and liquidity resources are available where needed within the financial system.

Implications for the financial system of guarantee schemes and other fiscal measures to protect the real economy

The COVID-19 pandemic and the resulting containment measures are a severe shock to European economies. National and EU authorities have swiftly taken a range of decisive measures to support the liquidity and solvency of firms and to protect household incomes. These programmes primarily target non-financial sectors. However, they also have important implications for the financial sector on account of their design features and effectiveness. Instruments differ with regard to the sector targeted and each sector's implications for liquidity and solvency. Moreover, their phase-out designs, and other features of the measures, might have macroprudential implications. The ESRB is, therefore, undertaking a stock take of the measures implemented so far, and setting-up a framework for monitoring the macroprudential implications of these measures focusing on the cross-border and EU levels. **The General Board strongly encourages cooperation and information exchange between the relevant national**

[1] European Central Bank (ECB) Banking Supervision press release from 12 March 2020.

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fiscal and macroprudential authorities in order to help understand the effects the implemented measures have on financial stability.

Market illiquidity and implications for asset managers and insurers

The sharp fall in asset prices observed at the onset of the coronavirus pandemic was accompanied by significant redemptions from some investment funds and deterioration in financial market liquidity. Market conditions have stabilised most recently – to a large extent on the back of decisive actions taken by central banks, supervisory authorities and governments in the EU and globally. However, investment funds and insurers with regard to unit-linked insurance products may see further redemption pressures if the macroeconomic outlook worsens by more than is currently anticipated. In that context, the General Board identified two segments of the investment funds sector as particularly high-priority areas for enhanced scrutiny from a financial stability perspective.

- The first segment comprises investment funds with significant exposures to corporate debt. At the onset of the COVID-19 pandemic, there were significant redemptions from funds investing in corporate debt. Furthermore, investment funds hold a significant proportion of the stock of non-financial corporate bonds outstanding in Europe. Any future redemptions pressures from open-ended funds with short redemption periods could result in fund managers selling less liquid assets quickly, thereby contributing to a deterioration in liquidity conditions in corporate debt markets. This could have adverse spillovers on other financial institutions with exposures to these assets (such as insurance companies, pension funds or banks) or an adverse impact on the cost and availability of market-based financing for non-financial corporations.
- The second segment identified by the General Board comprises investment funds with significant exposures to real estate. The necessary public health restrictions required to contain the spread of COVID-19 could result in a reduction in real estate market transactions and an increase in valuation uncertainty. Real estate investment funds are estimated to account for approximately one-third of the EU commercial real estate market. Any potential future redemptions from investment funds that have significant real estate holdings, if associated with real estate asset sales in an environment of low transaction volumes, could contribute to downward real estate valuation pressures. This could have adverse implications for other financial institutions with exposures to real estate (including through the use of real estate as collateral for lending).

In that context, the General Board adopted a Recommendation to the European Securities and Markets Authority (ESMA) to coordinate with the national competent authorities in undertaking a focused piece of supervisory engagement with investment funds that have significant exposures to corporate debt and real estate assets. The objective of the engagement is to assess the current state of preparedness of these two fund segments to potential future redemption pressures, further declines in market liquidity or increased valuation uncertainty, while also considering any steps that could enhance that preparedness.

More broadly, the General Board highlighted that liquidity management tools available to fund managers can help to mitigate 'first-mover advantage' dynamics and the risk of asset fire sales. Individual fund managers often have a range of tools at their disposal to use in such situations, including swing pricing and redemption gates, although there is significant variation in the availability of those tools both across EU jurisdictions and across market segments (e.g. between investment funds and insurers offering unit-linked products)[2]. Some asset managers have already employed these tools in the light of the deterioration in market liquidity and rising redemption requests observed at the onset of the coronavirus shock. In addition to helping to protect investors, the timely use of liquidity management tools (including those that promote an adequate allocation of redemption costs) also reduces the risk of forced sales of less liquid assets in periods of stress, helping to guard against the adverse system-wide effects stemming from fire sale dynamics across the financial system. **To this end the General Board emphasised that it is important that liquidity management tools are used in a timely manner, as necessary in such circumstances, especially by funds that invest in less liquid assets or assets that become temporarily illiquid and have short redemption periods.**

Impact of large-scale downgrades of corporate bonds on markets and entities across the financial system

The economic disruptions caused by the coronavirus pandemic could trigger a wave of credit rating downgrades in the corporate bonds sector due to the systemic increase in credit risk. These downgrades can be problematic, in particular for issuers losing their investment grade status, because of the cliff effects this might create (as BBB-rated corporate bonds represent roughly 60% of the investment grade universe). For example, index-tracking funds would need to sell those issuers' bonds quickly if they are removed from the reference basket. Other investment funds, banks, pension funds and insurers may decide, or be forced, to sell – for example because of their risk limits, because of their investment mandates, or to protect their solvency positions. Such sales could result in large spread increases, given the limited absorption capacity of the high yield market, leading to mark-to-market losses for investors and higher funding costs for corporates. From the macroprudential perspective it is therefore important to ensure that the effects of these credit rating downgrades are well understood and do not impair the functioning of financial markets so that the negative effects on the real economy are minimised. **These issues are discussed in a note that the ESRB publishes today. Furthermore, the General Board decided to coordinate a top-down analysis, with the European Supervisory Agencies and the European Central Bank, to assess the impact of a common scenario of large-scale downgrades across all parts of the financial sector (banks, investment funds, insurers, pension funds and financial markets).**

System-wide restraints on dividend payments, share buybacks and other pay-outs

A number of ESRB member countries and institutions at the European level – the European Banking Authority (EBA), the European Central Bank (ECB) and the European Insurance and Occupational Pensions Authority (EIOPA) – have encouraged banks and insurance corporations in the European Union to restrain voluntary

[2] See recommendation A of the 2017 ESRB recommendation on liquidity and leverage risks in investment funds.

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pay-outs (including dividends, bonuses and share buybacks aimed at remunerating shareholders).[3] Where enforced, these measures help to remove potential stigma attached to financial institutions choosing to preserve their capital resources in these times of crisis. This can enhance the resilience of the financial sector, strengthening its capacity to lend to the real economy in the crisis situation, while also reducing the risk of financial institutions failing. **The General Board supported the actions taken so far and stressed the value of applying pay-out restrictions in times of crisis.**

Liquidity risks arising from margin calls

The COVID-19 pandemic and the recent oil market disruptions have caused a sharp drop in asset prices and increased volatility, resulting in significant margin calls across centrally cleared and non-centrally cleared markets. The General Board discussed two financial stability-related issues: (i) high amounts of margin calls since mid-February, which could increase further due to likely forthcoming credit ratings downgrades and possible further market volatility; and (ii) possible adverse liquidity impact on both bank and non-bank entities, also in view of high degrees of market concentration and interconnectedness. **The General Board stressed the importance of: (i) mitigating procyclicality that could be linked to the provision of clearing services and to the exchange of margins in bilaterally cleared markets; (ii) enhancing central counterparty stress test scenarios for the assessment of liquidity needs; and (iii) limiting excessive liquidity constraints related to margin collection.**

The ESRB continues work in the five priority areas and the next extraordinary meeting of the General Board will take place on 27 May 2020.

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[3] On 27 March 2020, the ECB issued a Recommendation that, at least until 1 October 2020, no dividends are paid out and no irrevocable commitment to pay out dividends is undertaken by the credit institutions for the financial years 2019 and 2020 and that credit institutions refrain from share buy-backs aimed at remunerating shareholders. This Recommendation was addressed to significant institutions directly supervised by the ECB and to national competent authorities (NCAs) with regard to less significant banks. This was followed by an EBA statement on 31 March urging "banks to follow prudent dividend and other distribution policies, including variable remuneration". Many NCAs subsequently issued their own regulatory announcements in a similar vein. EIOPA issued a statement on 2 April calling on insurance companies to "temporarily suspend all discretionary dividend distributions and share buy backs aimed at remunerating shareholders", as well as suggesting they review their variable compensation policies. However, the follow-up at national level was mixed, with some authorities reiterating the recommendation made by EIOPA, and others calling for company-by-company consideration, while many authorities simply did not issue any statement.

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