European Financial Stability and Integration Review 2022

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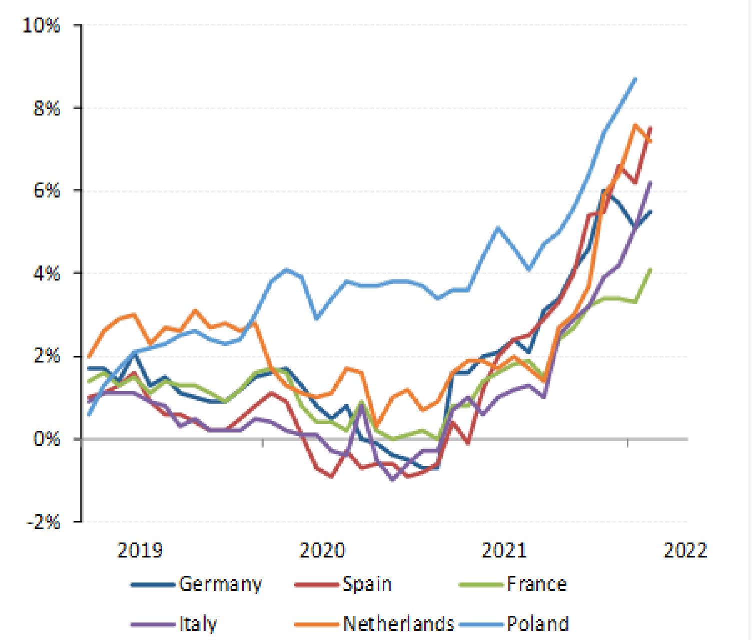
Robust recovery in 2021...

- Strong rebound in economic activity as restrictions were lifted
- EU unemployment rate fell to record low as labour markets recovered strongly
- Financial markets remained resilient in 2021 despite a challenging environment

...but rising price pressures

- Stronger-than-expected inflation caused by ongoing supply chain bottlenecks and other factors

Inflation(*) in EU Member States



Source: Eurostat; Commission Winter Forecast
(*) Headline HICP, y-o-y % change. Monthly data.

Financial stability risks before the Ukraine crisis

Still elevated vulnerabilities

- high corporate debt levels and increased sovereign debt levels
- rapidly increasing real estate prices

Financial stability mainly threatened by

- risk of disruptive repricing in financial markets
- increased corporate risks for highly levered firms and SMEs
- resurging stress in parts of the EU banking sector
- inflation outlook

Policy measures

- policy measures helped to stabilize the financial sector in 2021

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Focus on impacts from the Ukraine crisis

Following the start of the war – main adjustments:

- general uncertainty in markets,
- economic sanctions,
- further de-risking,
- Russian counter-measures.

Ukraine crisis: Measures taken so far

4 packages so far. As regards financial transactions:

1. **Ban of new financing**
2. **Restrictions for EU CSDs**
3. Banning new **listing of Russian securities in EU**
4. Prohibition of **selling EUR-denominated securities to Russia**
5. Cap on bank **deposits by Russians**
6. **Asset freeze of three Russian banks**
7. **Cutting 7 Russian banks off SWIFT**
8. Restrictions wrt RU Central Bank
9. Ban of **co-financing projects**
10. Prohibition to provide **euro banknotes** to Russia
11. **Extension to Belarus**
12. **Ban on CRAs to provide ratings and services** to Russian clients

Blue: outflows
Green: inflows
Black: other

Ukraine crisis: Impact on Russia

Strong immediate impact on Russian financial markets:

- sharp decrease in share prices and the exchange rate,
- widespread stress in other segments, liquidity withdrawals,
- stock markets closed for around a month,
- risk of default and ratings slashed to pre-default levels by CRA.

Massive policy interventions by the Russian authorities at a cost for the Russian economy:

- some short-term stabilisation of the Russian financial sector and the ruble.

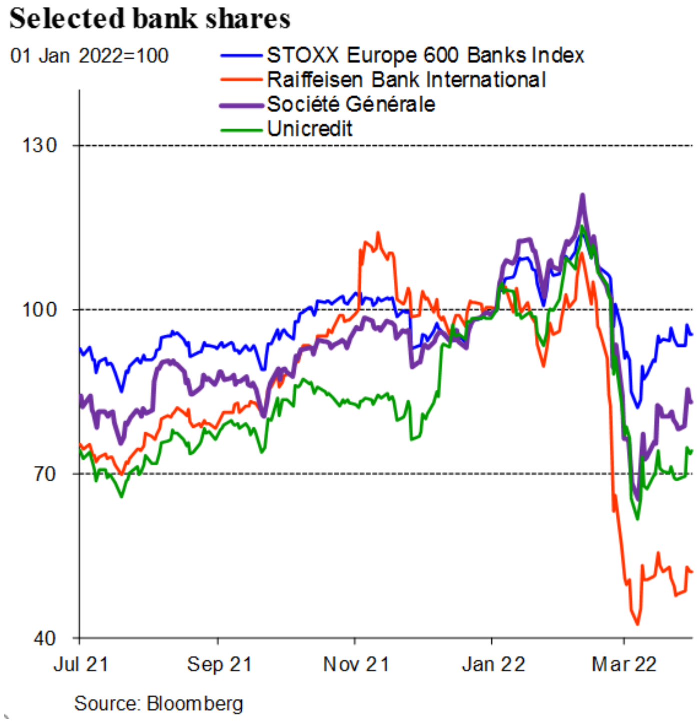
High strain on the Russian financial sector to continue:

- compounded by the long-lasting effects of Western sanctions and the deep recession.

Ukraine crisis: Impact on EU (1)

1. Exposure channels

- **Overall very limited exposure** of banks, other financial institutions, and financial-market infrastructure companies to Russian counterparties
- **Three large EU banks with large subsidiaries** in Russia:
  particular exposure to Russian financial-sector turmoil, recession and counter and retaliatory measures
- **Some EU CSDs with exposure to Russia** that will have to be cancelled under EU sanctions regime
- **Some very few EU subsidiaries of Russian banks**, with unavoidable ramifications (e.g. Sberbank Europa, VTB Europe, …)



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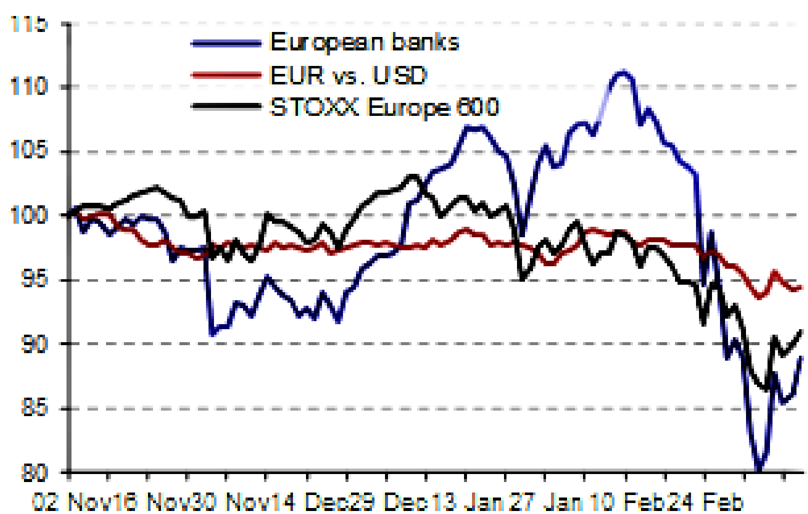
Ukraine crisis: Impact on EU (2)

2. Broader market and other channels

- Share prices, particularly of financial institutions, fell quite strongly in the week(s) following the Russian invasion of Ukraine
- Highly volatile commodity prices

Broad market indices (2 November 2021=100)



Source: Bloomberg

European gas futures prices
Dutch TTF Gas Apr 22 (TGJ22)
most recent value: 7 Mar 2022; 12:00

Source: Bloomberg

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Ukraine crisis: Impact on EU (3)

3. Medium-term risks

- **EU economy**, still recovering from COVID, sliding into stagnation
- **Cyber risk** emanating from Russia
- **EU banks in Russia** might further suffer from political, economic and financial crisis in Russia
- Less production and supply of agricultural goods might lead to **surging food prices**
- Cutting off Russian companies from **commodity markets** might strain markets
- **Some EU investment funds** might incur losses
- Possibility of Russian **government default**

4. Other effects

- **Regulatory or retaliatory Russian measures**
- Further attempts to **insulate and seek autonomy on Russian side in the long term**
- Possible loss of markets for our financial companies and the euro
- Fragmentation of markets

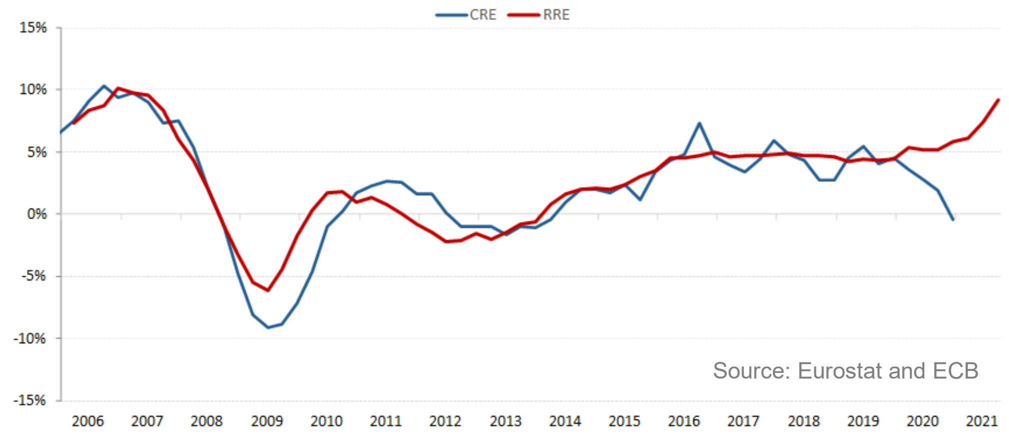
Systemic real estate risks and macroprudential policy tools

Real estate market conditions

Commercial real estate (CRE)

- Diverse market
- COVID-19 causing corrections in some segments like retail, hotel, and offices
- Long-term structural changes could add to pressures in certain segments

CRE and RRE price growth in the EU



Residential real estate (RRE)

- In recent years, prices and mortgage lending have been rising in most EU markets
- Conditions better than before the Global Financial Crisis (GFC):
  - overall, more prudent banking system and lending thanks to policies taken after GFC
  - short-term risks during the COVID-19 crisis mitigated thanks to policy measures taken
- Significant house price corrections could however still trigger medium-term systemic risks
  - lower growth and higher inflation and interest rates could increase risks of price corrections in countries with overvaluation, high indebtedness, high bank exposures and variable rates

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Toolkit to address vulnerabilities

Measures to curb imprudent lending and bolster banks' resilience to property shocks

- mainly directed at RRE markets
- include tighter capital requirements such as higher risk weights and sectoral buffers and
- borrower-based measures like loan-to-value (LTV) and debt-service-to-income (DSTI) limits

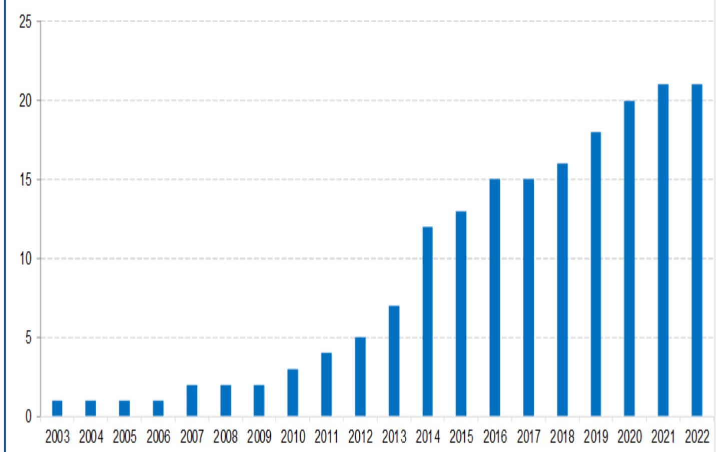
Macroprudential policy tools far less used for CRE markets

Review of macroprudential framework for banking

- Framework introduced in 2013 in Union law, aims at limiting the build-up of system-wide risks in the banking sector
- Opportunity to take lessons learned into account:
- Authorities opted for different solutions to increase banks' resilience for real estate risk and did not consider each instrument to be equally adequate.

Borrower-based measures developed and used in most Member States

Member states that have activated borrower-based measures for RRE



Source: ESRB

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Policy considerations

- **Important to remain vigilant and take necessary policy measures**
- **Macroprudential review to ensure that the toolkit remains fit for purpose:**
  - Assess effectiveness and consistency of tools, like risk-weight measures and sectoral systemic risk buffers, in addressing systemic risks and vulnerabilities related to real estate markets across the EU, and options to improve this
  - Linked to broader discussions around buffer usability, to ensure that banks would be able absorb losses while maintaining the provision of credit
  - Examine to what extent the effectiveness and efficiency of borrower-based measures can be increased in a European context
- **Increase understanding of climate change** impact on property because:
  - extreme weather events that depress property prices are more likely to take place
  - energy efficiency becomes more strategically and environmentally important
- **Structural changes** (e.g. remote working, demand for office spaces and shops) brought about **by the pandemic** require further attention to:
  - asses its impact on property markets and other long-term trends

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Decentralised Finance

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Decentralised Finance (DeFi)

- Potential to replicate broad array of financial services
  - **Storage of wealth (stablecoins)**
  - **Lending, trading, derivatives, insurance**
- Decentralised digital environment powered by software – 'smart contracts'
- Public blockchains
- Quasi-anonymous basis using crypto asset wallets

Total net value locked in DeFi globally

Source: DeFi Pulse, 21 December 2021
Note: Values in USD billion. Daily data.

DeFi: Opportunities and risks

Opportunities

- Substantial opportunities for financial integration across borders
- Geographical diversification as an additional risk-sharing element
- Coexistence of traditional finance and DeFi as differently organised financial ecosystems could promote financial system diversity

Risks

- Financial stability risks due to heavy reliance of collateral lending chains, and run-risk in the case of stablecoins
- In addition, other risks such as money laundering, terrorist financing and fraud risk

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Policy considerations

Adapting regulatory framework to DeFi may be challenging

- Financial sector regulation has traditionally focused on intermediaries
- More emphasis on activity-based regulation?
- Link between traditional finance and the crypto asset ecosystem?
- Future compliance of DeFi protocols, and respective responsibilities of actors deploying them?
- Embedded supervision?

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