



ESRB

European Systemic Risk Board

European System of Financial Supervision

Press release

8 December 2022

The General Board of the European Systemic Risk Board held its 48th regular meeting on 1 December 2022

At its meeting on 1 December 2022, the General Board of the European Systemic Risk Board (ESRB) noted that risks to financial stability have increased over the past few months. This reflects persistently high inflation, a tightening of financial conditions and a perceptible deterioration in the economic outlook. While third-quarter GDP growth in the European Union turned out better than expected, a prolonged period of low growth and elevated inflation, driven in part by surging energy prices, could give rise to renewed balance sheet stress in the non-financial corporate and household sectors and an upward shift in the number of insolvencies. This could be compounded by a turn in the housing cycle in a number of countries amid declining debt servicing capacity among households.

While the significant fall in asset prices in the course of 2022 has been largely orderly, risks to financial stability stemming from a possible sharp asset price correction remain elevated. Such corrections could be triggered by a further deterioration in the macroeconomic outlook, uncertainty about the path of monetary policy amid prolonged elevated inflation, or an escalation of geopolitical tensions. Asset price corrections could be amplified by high volatility and low market liquidity, signs of which were observed in the last few months across various fixed income instruments. Increased market volatility in conjunction with lower liquidity could compound the risk of disorderly adjustments, particularly if highly leveraged investment funds with a pronounced liquidity mismatch were to be forced to sell assets at short notice to meet redemption requests or margin calls.

The General Board also discussed asset quality and profitability prospects in the EU banking sector. It noted that the EU banking system appears stronger in terms of its capital and liquidity positions than in the past. Furthermore, banks have been benefiting from the normalisation of interest rates. Looking forward, however, several factors are expected to affect the asset quality and profitability outlook for banks: (i) the deterioration in the macroeconomic outlook and tighter financing conditions for borrowers; (ii) rising wholesale funding costs, most notably for banks with lower ratings and a shortfall in the minimum requirement for own funds and eligible liabilities (MREL); and (iii) a prospective decline in credit demand, with its impact on lending volumes, and a potential increase in operating expenses. In this light, the General Board considered it crucial for banks to reflect a severe deterioration in the risk environment in their risk management and capital planning, including by fully incorporating and regularly updating adverse scenarios for assessing credit, liquidity and market risks.

The General Board also discussed systemic risk that could emanate from significant price corrections in residential real estate markets and the decline in the real disposable income of borrowers. Members saw increasing evidence that the real estate cycle in several EU countries might be reaching a turning point because of the pronounced rise in mortgage lending rates since the beginning of the year and the deterioration in the macroeconomic outlook. They noted that transaction data and forward-looking household survey responses showing a decline in intentions to buy or build a house suggested that the probability of prices declining in the near future was rising.

When discussing vulnerabilities in the commercial real estate (CRE) markets, the General Board emphasised the impact of tightening financing conditions and heightened economic uncertainty on the profitability of this sector. A correction in CRE markets amid a reversal of the post-pandemic recovery in this sector could induce investor losses, increase credit risk for bank and non-bank lenders and prompt a decline in collateral values. Members emphasised that vulnerabilities in this sector were compounded by structural changes, including the impact of climate-related policies and the shift towards e-commerce. The General Board highlighted that the above risks are subject to significant cross-country and -sector heterogeneity that should be properly taken into account in potential policy responses. It welcomed the report on vulnerabilities in CRE markets in EEA countries, which will be published at the beginning of 2023.

The General Board noted that the environment of heightened cyber threats calls for a step increase in system-wide cyber resilience in Europe. The forthcoming Digital Operational Resilience Act (DORA), which the Joint Committee of the European Supervisory Authorities has already started preparing for, will improve cyber resilience at the level of individual entities. Threat-led penetration tests mandated by DORA, such as the EU Threat Intelligence-based Ethical Red Teaming (TIBER-EU), are important and provide a first line of defence against cyber incidents. The General Board highlighted that further lines of defence against cyber incidents would increase the resilience of the financial system as a whole.

Against this background, the General Board discussed analytical and policy tools, noting that urgent work is now needed to operationalise the analytical tools and identify and close gaps in policy tools. The General Board highlighted the benefits of the Cyber Resilience Scenario Testing approach and encourages authorities to implement pilot tests. It also noted that it was crucial for authorities to define and adopt the use of Systemic Impact Tolerance Objectives in their approach to cyber threats. These findings will be summarised in an ESRB report, which will be published early in 2023. The ESRB continues to work in these areas as a hub to share progress reports and good practice, and to update the conceptual approach, encompassing the experiences and insights gained from pilot tests.

The General Board also discussed the adverse scenario for the European Banking Authority's (EBA) 2023 EU-wide stress test. The adverse scenario will be finalised by the General Board at the end of January 2023 and published when the EBA launches the EU-wide stress test.

The General Board appointed six new members to the Advisory Scientific Committee (ASC):

- Bruno Biais, Professor of Finance, HEC Paris
- Laurent Calvet, Professor of Finance, EDHEC Business School
- Christian Gollier, Managing Director, Toulouse School of Economics
- Vasso Ioannidou, Professor of Finance, Bayes Business School
- Robin Lumsdaine, Chair of Department of Finance and Real Estate, American University
- Xavier Vives, Professor of Economics and Finance, IESE Business School

The General Board also reappointed four members to the ASC:

- Stephen Cecchetti, Rosen Family Chair in International Finance, Brandeis International Business School
- Kathryn Dominguez, Professor of Public Policy and Economics, University of Michigan
- Martin Oehmke, Professor of Finance, London School of Economics and Political Science

- Javier Suárez, Professor of Finance, CEMFI

The terms of office of all these appointees will start in May 2023. They will join Thorsten Beck, Bo Becker, Lorian Pelizzon, Enrico Perotti and Richard Portes, whose mandates are ongoing.

The General Board expressed its sincere gratitude to Willem Buiters, Elena Carletti, Sebnem Kalemli-Ozcan, Malcolm Kemp, Giovanna Nicodano and Lars Svensson, whose mandates on the ASC are finishing at the end of April 2023.

Finally, the ESRB today released the 42nd issue of its risk dashboard. The risk dashboard is a set of quantitative and qualitative indicators measuring systemic risk in the EU financial system.

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