Olli Rehn: Addressing systemic risks to financial stability in the European Union

Speech by Mr Olli Rehn, Governor of the Bank of Finland and First Vice-Chair of the European Systemic Risk Board (ESRB), to the CFA Institute Systemic Risk Council, Washington DC, 18 December 2024.

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Presentation accompanying the speech

Esteemed members of the CFA Institute Systemic Risk Council,

May I first thank the Systemic Risk Council for the invitation. It is a great honour to speak before such a distinguished audience. I am looking forward to hearing your views and I hope we can have a lively discussion after my talk.

Let me start with a snapshot of our financial stability journey: since the global financial crisis, we have gained a sharper understanding of the systemic vulnerabilities in our financial system. The last 15 years have underscored the importance of financial stability as a cornerstone for effective central banking.

During this transformative period, seminal work, by Ben Bernanke, Charles Kindleberger, Hyman Minsky and others, has provided a rich theoretical foundation for understanding these risks.

Bernanke shows that inadequate monetary policy and financial market failures can turn economic shocks into prolonged depressions. His emphasis on the role of central banks as lenders of last resort, combined with the concept of the financial accelerator, greatly helped to frame the policy responses to the global financial crisis and reduce the risk of another Great Depression.

Kindleberger and Minsky illustrate how financial instability is not merely a by-product of irrational behaviour, but an almost inevitable aspect of financial cycles dubbed by Minsky as the "financial instability hypothesis". To quote Kindleberger: "The essence of financial crises is that they are all alike". This suggests that, while details differ, systemic patterns persist.

Globally, we have made notable strides in this domain. In the European Union, our enhanced regulatory and supervisory frameworks, ranging from increased capital requirements to advanced macroprudential policies and all the way to the banking union, have played a pivotal role in shielding the financial system from recent global shocks. The European Systemic Risk Board (ESRB) has made an important contribution to these efforts and is an essential part of the macroprudential architecture in the EU. Nevertheless, emerging challenges, particularly from the non-banking sector and cyber risks, remind us only too well that vigilance remains paramount.

Looking ahead, the completion of the Basel III regulatory reforms described by some as the "Basel endgame" remains critical. The Basel III framework, with its stringent capital and liquidity standards, addresses key vulnerabilities by ensuring banks hold adequate reserves to withstand financial disruptions. Even as debates unfold across the Atlantic, with the incoming US administration re-evaluating regulatory priorities, it is essential to remind ourselves that robust implementation of Basel III is a foundational building block for long-term financial stability.

[Slide 2 Roadmap of today's talk]

As you can see on this slide, I will first give you an overview of the ESRB and its functions. Next, I will discuss key risks to EU financial stability, based on the ESRB's recent systemic risk assessment and major trends behind these risks. Finally, I will share some thoughts with you on how we believe the ESRB needs to change and develop in the continuously evolving systemic risk landscape.

[Slide 3 ESRB organisational chart]

The ESRB benefits from a large and diverse membership. At the General Board there are national supervisory authorities, national central banks, the ECB, the European Supervisory Authorities (ESAs), the Commission.

In addition to the Steering Committee, which sets strategy, there are two Advisory Committees, technical and scientific, that are both created by statute.

The Advisory Technical Committee considers topics from a policy perspective and is the primary operational arm of the ESRB. It is the central hub for the ESRB's analytical work.

The Advisory Scientific Committee, adopts a more academic perspective. Composed of 15 external academic experts plus the Chair of the Advisory Technical Committee, it conducts research and provides advice to support other parts of the ESRB's structure.

[Slide 4 Key risks in the EU financial system]

Despite the challenges in the macro-financial environment over the past few years, the EU financial system has remained resilient.

Let me summarise our current view of the key risks to EU financial stability.

[Slide 5 Macro-risks: Pursuing growth while nurturing financial stability]

In our latest risk assessment, we have identified three key financial stability risks facing the EU financial system. These are outlined on this slide. They concern: (1) the macroeconomic environment and potential balance sheet stress in the private sector; (2) vulnerabilities in financial markets that can lead to disorderly market corrections; and (3) deteriorating asset quality, and consequent funding risks in the banking sector.

Overall, risks to financial stability in the EU have increased over the past months amid high political uncertainty and elevated geopolitical tensions. This is reflected in the emergence of several plausible triggers for tail risk scenarios. These include new major trade restrictions and the escalation of the Russian illegal war in Ukraine or the tragic conflict in the Middle East. Related to this, the EU economy has faced increasing number of cyberattacks and acts of hybrid warfare. These factors may intensify macroeconomic, credit and market risks and make financial markets and commodity prices more volatile.

The first financial stability risk relates to a weak macroeconomic environment and potential balance sheet stress in the private sector, which has so far been resilient. While the economic outlook is slowly improving, there are two particular issues of concern in the longer-term outlook for the EU: geoeconomic fragmentation and low productivity growth.

In recent years, geopolitical tensions have risen substantially with Russia's war in Ukraine, the conflict in the Middle East and China's strategic aims. The rise in geopolitical tensions is greatly contributing to an increasingly uncertain and volatile global environment and it also has significant implications for Europe.

Overall, the exposure of euro area bank assets from high-risk countries is low, so the direct risks in the banking sector are limited. In 2024 Russia, China and the Middle East account altogether only for around 5% of euro area banks' assets. Banks in the euro area have also reacted quickly to increased country risks. This is evident in the monthly development of the foreign corporate loan portfolio, which you can see in the graph on the left.

We are more concerned about indirect macroeconomic impacts via trade wars, protectionism and geoeconomic fragmentation. Geopolitics is shaping the economic operational environment and is likely to have long-term adverse effects.

This leads me to the marked slowdown in productivity growth, which is Europe's Achilles heel. The EU's persistent productivity gap in relation to the United States has widened further in the past few years, as per the graph on the right.

The need for Europe to pursue stronger productivity growth on all fronts is a key challenge, as outlined in former ECB President Mario Draghi's recent report. In pursuit of productivity and economic growth, Europe should support better distribution of new technologies, improve access to finance and remove existing barriers to cross-border services.

However, when we talk about actions to accelerate economic growth, it also inevitably means taking more risks. It is important in these discussions that we do not take the stability of the financial system for granted.

When memories of crises fade and the financial system remains stable for a longer period, discussions about deregulation tend to gain momentum – as we are now witnessing. But taking the deregulation route would be very short-sighted from the financial stability perspective.

[Slide 6: Market risks: Promoting capital markets union while managing the non-bank financial intermediation sector's systemic risks]

The second risk identified by the ESRB relates to financial markets, where the risk appetite has been unusually strong, especially in the context of high macro-financial uncertainty. The abrupt, albeit short-lived, market correction in early August showed how sensitive the risk appetite can be to shocks, and further corrections may come.

In the EU, promoting the savings and investment union – or capital markets union has gained new impetus over the past year. I believe that a better functioning and more unified European capital market would promote EU competitiveness and distribution of risk. It would also reduce the bank-centric nature of the EU financial system and the resulting vulnerabilities.

At the same time, we must ensure that the risks in the non-bank sector are managed effectively, including at the systemic level.

There has been active discussion in the EU this year about the need to extend macroprudential instruments beyond the banking sector, especially to the investment fund sector. This has been motivated by the significant growth of the investment fund sector. It is important, too, that we properly understand the interconnections and dynamics between banks and non-banks.

[Slide 7: Bank risks: Sturdy capital buffers provide resilience but new threats need to be addressed]

Finally, the third identified risk concerns the banking sector. Vulnerabilities in the banking sector could emerge, especially if the first two risks materialise. This could increase credit risks and tighten financing conditions.

So far, the EU banking sector has remained stable and resilient, due at least in part to the financial regulations in place as well as micro- and macroprudential policies. Profitability has increased significantly in recent years while the capital ratios of euro area banks have approximately doubled since the global financial crisis. However, although higher bank capitalisation protects banks from traditional risks, such as credit risks, new risks create new concerns.

Digitalisation has led to significant cost savings for banks as customers can conduct many of their bank business at home on their computers. At the same time, as we learned the hard way from the deposit flight in the United States a little over a year ago, increased digitalisation may also make banks more vulnerable to liquidity risks. Sooner or later, new technological advances, such as artificial intelligence and quantum computing, will bring profound changes to the functioning and structures of economies, finance and society in general. It is essential that we understand the relevance of these technologies and the use of big data in relation to systemic risks.

The vulnerabilities and risks from the climate and nature crises can no longer be categorised as long-term issues; they require our immediate attention. Cybersecurity is also a challenge for banks, as geopolitical tensions take cyber risks to a new level and present hybrid and physical cyber risks. A recent prominent example of this is the damage to telecommunications cables in the Baltic Sea.

These factors should also be properly taken into account in our own analysis of systemic risks. A lot of work has already been done, but there is still a lot of room for improvement, especially on potential macroprudential tools in these areas.

[Slide 7 Priorities in developing the ESRB]

Given the constantly evolving environment, the ESRB's mandate and set-up need to be reviewed from time to time. The European Commission is currently tasked with reporting on the review of the ESRB to the European Parliament and to the Council of the European Union.

For this purpose, the ESRB has established a High-Level Group to identify what changes to the ESRB's mission or framework might be necessary, and to provide insights to the EU's co-legislators prior to the review process. I have the honour of chairing this group.

The High-Level Group will soon publish a report on the future of the ESRB. Let me highlight a few priorities that I consider important for developing the ESRB and that are likely to be reflected in the report.

First of all, it is important that the ESRB's focus should move towards a holistic assessment of systemic risks in the EU financial system. Given its large and diverse membership, including national supervisory authorities, national central banks, the ECB, the European Supervisory Authorities (ESAs), the Commission, etc., the ESRB has a unique ability to examine cross-sectoral, cross-border and interlinked risks – the truly systemic dimension of the risks.

A holistic assessment of systemic risks to financial stability in the EU would also require a system-wide stress testing framework that would allow consistent analysis and assessment of vulnerabilities across the key sectors of the EU financial system. The stress testing framework would need to be complemented with other more qualitative sources of information, including market intelligence and expert judgement.

To further develop its assessment of systemic risks in the EU, the ESRB would need comprehensive and sufficiently granular EU-wide data covering both banks and non-banks. In particular, improving data sharing between ESAs and the ESRB would be necessary to assess interconnections between different entities and segments in the EU financial system.

In addition to enhancing systemic risk analysis, the ESRB will deepen its analysis of macro-financial vulnerabilities in EU Member States and assess how macroprudential policy measures enhance the resilience of the financial system against identified risks. This kind of assessment of national macroprudential policy stances could feed into the EU's macroeconomic imbalance procedure.

Finally, it is essential to strengthen the ESRB's communications on financial stability, systemic risks and macroprudential policies. Even perfect systemic risk assessments would be of little value if they, and consequent policy conclusions, cannot be effectively communicated to the financial industry, other stakeholders and the general public.

Let me now conclude. Financial stability fundamentally depends on the geopolitical and macroenonomic context. The best for EU financial stability at this juncture is to maintain European unity and firmly support Ukraine in the face of Russia's war.

Furthermore, it is crucial to strengthen the structural foundations of the European economy by focusing policy actions on productivity growth and industrial competitiveness, while retaining the European model of social inclusion.

The ESRB, together with the ESAs, the ECB, the national central banks and supervisory authorities, continues to play a key role in safeguarding the stability of the EU financial system. Our work will focus on the evolving systemic risk and will be based on comprehensive data and research, high-quality analysis, and wide-ranging cooperation between authorities.

Today, I have outlined to you the main systemic risks that we have identified and are currently analysing and monitoring at the ESRB. As I noted earlier, I would be most interested to hear your views concerning the global systemic risk landscape.

Thank you very much for your attention.