

# EU financial regulators highlight risks of a no-deal Brexit and search for yield

The 2019 Autumn ESAs' report highlights the following risks as potential sources of instability:

- Uncertainties around the terms of the United Kingdom's withdrawal from the European Union
- Persistently low interest rates, which combined with flattening yield curves, put pressure on the profitability and returns of financial institutions, incentivise search-for-yield strategies and increase valuation risks
- Transition to a more sustainable economy and environmental, social and governance (ESG) related risks, leading to possible challenges to the viability of business models with high exposures to climate sensitive sectors.

In light of the ongoing uncertainties, especially those around Brexit, supervisory vigilance and cooperation across all sectors remains key. Therefore, the ESAs call for the following policy actions by European and national competent authorities (NCAs) as well as financial institutions:

- **Contingency planning:** Financial institutions and supervisors should continue their work on contingency planning and assurance of business continuity in the case of a no-deal Brexit. Considering the variety of measures undertaken by the ESAs and national supervisory authorities and other competent authorities, the EU financial sector should be well informed and prepared to manage risks from a micro-perspective. The ESA's will also continue to closely monitor ongoing political and market developments and consider the need for further communications on that basis.
- **"Low-for-long" scenario:** Supervisors and financial institutions should continue taking into account a "low-for-long" interest rate scenario and associated risks. Low interest rates are an important driver of low bank profitability and remain the main risk for the insurance and pension fund sectors. They contribute to the further build-up of valuation risks in securities markets as well as to a move into less liquid and more leveraged investments through search-for-yield strategies. On the investment fund side, a convergent application of the rules on liquidity management and (for UCITS) eligible assets as well as a consistent use of stress testing will be important supervisory tools.
- **Bank profitability:** There is a need to further address unprofitable banks and their business models in order to increase the resilience of institutions to a more challenging economic environment. Further investments into financial technologies and exploring opportunities for bank sector consolidation are among responses to low profitability. Transparency and the

consistent application of common prudential requirements and supervisory rules across jurisdictions are preconditions, which could contribute to the use of opportunities cross border consolidation, may offer.

- **Leveraged lending market:** Risks related to the leveraged loan market and Collateralized Loan Obligations (CLOs) in the financial sector should be further explored and identified. There is a lack of clarity about the total volume of leveraged loans outstanding and about the ultimate holders of risks of many CLO tranches. Supervisors have raised concerns about a possible underpricing of risks.

- **Sustainable finance and ESG risks:** Supervisory authorities and financial institutions should continue their work on identifying exposures to climate related risks and facilitate access of investors to sustainable assets. Scenario analysis and stress testing are important tools that can be implemented by supervisors with a goal to incorporate sustainability considerations into risk assessment. Financial institutions should incorporate climate risk and other ESG factors into their risk management framework and should play a stewardship role by taking into account the impact of their activities on ESG factors. Going forward, the ESAs should take a proactive stance in fulfilling mandates on sustainable finance, including on how ESG considerations can be incorporated into the regulatory and supervisory framework of EU financial institutions.

## **Background**

The Joint Committee is the forum for cooperation between the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), collectively known as the European Supervisory Authorities (ESAs).

Through the Joint Committee, the three ESAs cooperate regularly and closely to ensure consistency in their practices. In particular, the Joint Committee works in the areas of supervision of financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products and measures combating money laundering. In addition, the Joint Committee also plays an important role in the exchange of information with the European Systemic Risk Board (ESRB).