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COMMISSION STAFF WORKING DOCUMENT

**Completing the Scoreboard for the MIP:
Financial Sector Indicator**

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Completing the Scoreboard for the Macroeconomic Imbalance Procedure: Financial Sector Indicator

The initial scoreboard performed well to support the first application of MIP

In December 2011, after the conclusion of the legislative process, the '6-pack' entered into force, including a regulation setting up the Macroeconomic Imbalance Procedure (MIP)¹. In February 2012, the first step in the MIP was taken, when the Commission adopted and published the first Alert Mechanism Report (AMR)². The role of the AMR is to identify, on the basis of an economic reading of the scoreboard, which Member States may have an imbalance and for which in-depth reviews (IDRs) are warranted.

The AMR of February 2012 was based on a scoreboard established by the Commission in line with Article 4 of Regulation (EU) No 1176/2011. The scoreboard consisted of ten indicators covering the wide scope of surveillance under the MIP. The critical role of the scoreboard in the MIP should be recalled: The scoreboard is a filter with a view to signal issues for which more in-depth investigation is required, before concluding whether a Member State is affected by imbalances or excessive imbalances. As prescribed by Regulation (EU) No 1176/2011, no policy conclusions are drawn on the basis of a mechanical reading of the scoreboard, neither on the existence of imbalances or excessive imbalances, nor even on whether the situation is such that justifies an in-depth analysis. The scoreboard should be read and interpreted in its entirety and not in isolation from other relevant indicators and information, including the supporting set of so-called 'reading indicators,' which are also reported in the AMR.

On 30 May 2012, the Commission adopted IDRs for twelve Member States and the appropriate policy recommendations were put forward in the context of the European Semester. The twelve Member States for which IDRs were prepared under the first round of MIP were considered to have imbalances³.

While adjustments to the composition of the scoreboard are under the responsibility of the Commission (Article 4(7) of Regulation (EU) No 1176/2011), the Commission is committed to inform and work closely with the European Parliament and Council on the scoreboard design. Indeed, ahead of the first AMR, both the European Parliament and the Council were given the opportunity to provide their views on the Commission plans for the scoreboard⁴. On this basis, the Council provided its views on 8 November 2011 and similarly did the European Parliament on 15 December 2011.

¹ Regulation (EU) No 1176/2011 of the European Parliament and of the Council (OJ L 306, 23.11.2011, p. 25).

² COM(2012) 68 final, 14.2.2012.

³ These Member States were Belgium, Bulgaria, Denmark, Spain, France, Italy, Cyprus, Hungary, Slovenia, Finland, Sweden and the United Kingdom (see *European Economy-Occasional Papers*, 99 to 110, and Commission Communication 'Action for Stability, Growth and Jobs,' - COM(2012) 299 final, 30.5.2012).

⁴ 'Scoreboard for the surveillance of macroeconomic imbalances: envisaged initial design,' - SEC(2011) 1361 final, 8.11.2012, subsequently published in *European Economy—Occasional Papers*, 92.

The scoreboard should be completed with a financial sector indicator

Although the first vintage of the MIP scoreboard already captured a number of financial issues (like the private sector credit flow, the private sector debt and the public sector debt) the European Parliament⁵ and the Council⁶ supported the Commission's intention to add to the scoreboard, in time to the second round of MIP, an additional indicator aimed at better capturing the interlinkages between the real economy and the financial sector⁷. In turn, the ESRB provided its comments and views on the initial design of the scoreboard as well as on the plans for an additional financial sector indicator⁸.

Against this background the Commission services continued the technical work to develop a financial sector indicator. This work is now completed and further described below. It is envisaged to include the chosen indicator in the scoreboard for the second Alert Mechanism Report.

The identification of the new indicator has been supported by extensive technical work

The technical work to identify an appropriate financial sector indicator for the MIP scoreboard has been led by the Commission services, but has drawn on the expertise and inputs from Member States, the ECB as well as the views provided by the ESRB last year.

As it was the case for the indicators selected for the initial design of the scoreboard, the technical work to identify a suitable financial sector indicator was guided by a number of principles.

A first key aspect concerns the *economic relevance*. It should be recognised that no single indicator can capture all potential risks stemming from the financial sector. At the same time, the propagation of feedback loops, or in other words, the ability to magnify or attenuate vulnerabilities is a key dimension that the scoreboard should capture. This is also valid for other vulnerabilities and issues within the scope of MIP surveillance. However, while the scoreboard gathers a short list of relevant indicators, all available data and information need to be taken into account for the in-depth assessment of imbalances in Member States.

A second guiding principle concerns *simplicity*. For communication purposes, it is important to have a scoreboard indicator which is easy to grasp, even if more sophisticated complex tools may be used in other steps of MIP (like in the IDRs).

A third principle concerns *regulatory overlaps*. It is important to understand to what extent the indicators are the object of other surveillance or supervisory processes. A scoreboard indicator which is explicitly included in financial regulation with already set minimum

⁵ Point 9 of the European Parliament Resolution of 15.12.2011: 'The European Parliament (...) [T]akes note of the Commission's intention to provide, by the end of 2012 and in time for the subsequent European Semester, a new set of indicators and related thresholds for the financial sector'.

⁶ Point 9 of the ECOFIN Council Conclusions of 8.11.2011: '(...) The Commission is also requested to present, before the end of 2012 and in line with the Regulation, suggestions on an indicator related to the financial sector, with a view to its inclusion for the 2013 European Semester.'

⁷ Article 4(3)(a) of Regulation (EU) No 1176/2011 provides that the scoreboard should encompass, *inter alia*, '(...) internal imbalances, including those that can arise from public and private indebtedness, financial and asset market developments including housing (...).'

⁸ 'Views of the ESRB on the Envisaged Scoreboard Indicators Relevant for Financial Market Stability,' available for download at <http://www.esrb.europa.eu/pub/html/index.en.html>.

requirements would be incongruous, both because of overlapping concerns and even more so because of endogeneity considerations.

Finally, *data considerations* are also important. Data availability issues must be taken into account to ensure the quality of analysis and appropriate comparability of Member States. For example, some Member States do not yet report consolidated data in the financial accounts and balance sheets transmitted to, and collected by, Eurostat. Moreover, while data are available at the most aggregated level data, they are not always available at a disaggregated level, further constraining the options. Data considerations also concern timeliness, as the indicators which are selected for the scoreboard must be available on time for the AMR and other steps in the procedure.

In the technical discussions between the Commission services and the Member States⁹ experts, several indicators have been considered. A large consensus emerged that the two most relevant indicators to be considered for the scoreboard were:

- *the growth rate of liabilities of the financial sector* and
- *the debt-to equity ratio*, as an indicator measuring the leverage of the financial sector.

Other indicators that were considered in detail were:

- *the total financial liabilities over core financial liabilities*, *i.e.* an indicator aiming to capture the stickiness of funding. Core liabilities are broadly defined as financial institutions' liabilities to claimholders who are not financial intermediaries themselves. However, this indicator was judged as excessively complex and difficult to communicate to be used in the first filter of the procedure.
- *the loan-to-deposit ratio*, *i.e.* an indicator on the funding structure of the banking sector. This indicator was considered as very sensitive to differences in the liability structures and alternative financing options across Member States. Therefore, a common threshold for the AMR scoreboard would not be appropriate. Moreover, this indicator is relevant for the banking sector, but not for the financial sector as a whole.
- *the share of short-term liabilities in total liabilities* which measures the market-related refinancing needs of the financial sector in a Member State. Although liquidity has been key in the crisis, it is not the main objective of a financial indicator in the context of the MIP, and these liquidity difficulties often emerge as result of other vulnerabilities.

These three indicators scored all relatively low on data considerations, given the required detailed data, which could create problems for the appropriate comparability of Member States.

It is therefore envisaged to include in the scoreboard the growth rate of financial sector liabilities

⁹ At the technical level, the Economic Policy Committee (EPC), through its LIME working group, have been involved.

On the basis of the technical discussions, it is envisaged to include the growth rate of financial sector liabilities in the scoreboard, while retaining the leverage indicator among the set of reading indicators, thus taking into account both in the overall economic reading. In the technical discussion, this option was supported by a vast majority of Member States' experts. The other indicators that were discussed, and all other data, will be considered in the in-depth reviews, as appropriate.

The growth rate of financial liabilities has several advantages and fulfils well the above mentioned guiding principles. The indicator is a very broad measure of the expansion of the exposure to potential risks in the financial sector. Experience has shown that a fast expansion of the financial sector has often preceded financial crises. Among the several indicators that were discussed at the technical level, it was the one that had better early-warning qualities. A very rapid growth of the liability side of the balance sheet may be driven by excessive credit. Other indicators in the scoreboard, such as credit and private sector indebtedness also provide additional qualifying information in this respect. Given that this indicator does not require instrument disaggregation which is more prone to disentangling difficulties and reclassifications, the indicator provides a fairly reliable basis for comparison among Member States. Moreover, it does not discriminate against different funding specificities of Member States. The indicator is not specific to the business model of a specific subsector. In principle, the size of the financial sector can be measured on the asset or the liability side of financial sectors' balance sheet. The indicator is defined in a way that covers all financial corporations (sector S.12 in the European System of National and Regional Accounts: ESA), this is, all corporations and quasi-corporations which are principally engaged in financial intermediation (financial intermediaries) and/or in auxiliary financial activities (financial auxiliaries). The concept of liabilities to be considered is very wide: it covers currency and deposits (AF.2), securities other than shares (AF.3), loans (AF.4), shares and other equity (AF.5) insurance technical reserves (AF.6) and other accounts payable (AF.7). As for other indicators, the threshold (an annual growth rate of 16.5 per cent) is defined as the third quartile of the available distribution. As established in Article 3(2) of Regulation (EU) No 1176/2011, the interpretation of this indicator in the scoreboard will be neither mechanical, nor isolated from that of other indicators, but subject to an all-encompassing economic judgement.

It is envisaged to complement this indicator with a debt-to-equity ratio indicator in the second layer of reading indicators: The debt-to-equity ratio indicator shows the relative proportion of shareholders' equity and debt used to finance assets. The ratio provides information on the leverage building up within the financial sector which can have an amplifying impact on the economic cycle. A highly leveraged financial system may amplify unfavourable economic developments, like a recession, or doubts on the solvency of the sovereign. While leverage is important for growth, excessive leverage carries the threat of the amplification effect of the volatility of returns: since the absolute increase in value of returns is accelerated when leverage is employed, so are the losses. A drawback, however is that the indicator is largely influenced by market fluctuations in equity prices which must be considered in the interpretation of the indicator. Moreover, given the heterogeneity of financial system, it is not appropriate to define a threshold that is common to all Member States.

The scoreboard should be stable but the technical work to improve the quality and comparability of statistics should continue

The scoreboard must remain a simple and clear tool to work as a filter that helps focussing the surveillance under the MIP. In this context, stability in the scoreboard design over time is valuable. It is not foreseen at this point in time to add additional indicators to the scoreboard.

Against this background, the Commission is committed to improve the quality of the data. As prescribed by Regulation (EU) No 1176/2011, the Commission will regularly assess the appropriateness of this indicator, and of the whole scoreboard, and modify them as appropriate. To this end the Commission will continue liaising at a technical level with the Member States (including the statistical authorities), the ECB and the ESRB to ensure that the scoreboard remains up to date in its design and takes into account statistical developments. Moreover, the Commission will remain attentive to the need of adjusting the indicative thresholds.

Financial Corporations - Total Financial Liabilities (year-on-year growth rate)

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
BE	4.1%	-3.9%	9.3%	15.3%	15.7%	11.0%	12.1%	-6.9%	-5.0%	-2.0%	4.7%
BG	7.0%	7.5%	22.0%	36.6%	34.2%	52.0%	29.3%	-3.5%	0.9%	-2.4%	5.6%
CZ	10.5%	9.9%	3.1%	12.5%	17.0%	9.3%	19.2%	5.6%	3.7%	8.6%	0.9%
DK	6.9%	6.4%	8.7%	11.0%	20.7%	10.2%	10.5%	6.5%	0.9%	7.8%	5.0%
DE	3.0%	-0.5%	3.5%	3.6%	5.6%	4.8%	5.9%	1.9%	-1.1%	0.1%	2.1%
EE	13.3%	24.5%	13.4%	34.3%	23.4%	15.1%	27.8%	8.0%	-10.8%	-10.1%	-4.4%
IE	n.a.	8.8%	25.4%	20.4%	35.3%	20.4%	10.3%	6.5%	2.8%	6.2%	-0.6%
EL	0.8%	0.2%	8.6%	9.0%	16.8%	14.2%	22.1%	4.6%	10.2%	8.5%	-3.4%
ES	6.9%	4.6%	15.5%	15.1%	24.6%	19.0%	16.9%	4.7%	3.8%	-2.2%	3.7%
FR	5.2%	1.6%	6.4%	10.0%	15.1%	15.0%	13.1%	2.5%	0.2%	3.0%	7.3%
IT	-3.0%	3.9%	11.6%	7.2%	12.1%	10.5%	0.5%	-2.7%	5.7%	1.7%	3.8%
CY	7.8%	-4.3%	6.5%	19.4%	39.3%	28.6%	21.3%	15.0%	18.8%	-6.0%	-0.2%
LV	24.5%	13.0%	12.8%	30.6%	41.4%	47.6%	36.9%	5.9%	-8.3%	-0.1%	-3.2%
LT	24.5%	18.2%	31.6%	25.0%	48.9%	32.5%	34.3%	3.7%	-3.7%	0.0%	8.9%
LU	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	15.1%	-11.8%	6.1%	12.4%	11.3%
HU	15.1%	9.6%	7.9%	24.5%	17.8%	18.5%	12.5%	9.0%	6.7%	0.4%	-14.0%
MT	n.a.	n.a.	n.a.	n.a.	29.4%	14.3%	22.3%	10.0%	-0.4%	18.5%	1.4%
NL	8.1%	0.3%	9.4%	6.0%	14.8%	12.1%	16.3%	-0.6%	6.1%	6.8%	7.2%
AT	5.3%	0.7%	6.6%	11.3%	16.5%	10.0%	9.4%	11.8%	-1.7%	-1.7%	-0.3%
PL	23.9%	-11.6%	0.1%	32.6%	26.3%	25.2%	26.7%	-7.4%	10.9%	17.0%	-7.0%
PT	6.2%	2.6%	9.6%	2.8%	9.8%	11.3%	9.9%	5.4%	9.5%	10.0%	-0.7%
RO	32.9%	13.1%	9.3%	70.2%	57.1%	47.2%	26.8%	0.2%	8.6%	3.7%	2.9%
SI	n.a.	18.2%	9.5%	10.1%	17.8%	13.7%	28.5%	6.6%	7.4%	-3.4%	-1.3%
SK	12.3%	42.6%	6.8%	7.7%	19.1%	-7.5%	24.8%	8.9%	-5.0%	2.2%	1.2%
FI	8.3%	3.3%	13.3%	14.6%	13.6%	12.2%	10.5%	16.4%	6.5%	18.9%	30.8%
SE	0.5%	-1.7%	11.3%	12.6%	10.4%	16.3%	3.5%	-3.7%	12.5%	16.7%	4.2%
UK	7.8%	-7.0%	5.0%	30.0%	22.5%	13.7%	6.9%	13.6%	-11.3%	11.4%	11.8%

Source: Eurostat.

Cut-off date: 6 November 2012.