ESRB
European Systemic Risk Board
European System of Financial Supervision

Press release

25 February 2020

Report on the macroprudential implications of Level 2 and 3 financial instruments for accounting purposes

The European Systemic Risk Board has today published a report on the macroprudential implications of financial instruments that are measured at fair value and classified as Level 2 and Level 3 instruments for accounting purposes.[1]

Supervisory data from the European Banking Authority show that EU banks[2] had fair value financial assets totalling €7,279 billion on their balance sheets in December 2018 (accounting for around 25% of total assets), with €2,379 billion in Level 1 (mostly debt securities), €4,600 billion in Level 2 (mostly derivatives) and €300 billion in Level 3. Relative to the situation at the end of 2016, data for December 2018 show a sizeable decline in the total value of financial instruments measured at fair value, driven by a decline in derivative positions.

Conceptually, the report identifies three main areas where financial instruments measured at fair value can affect financial stability and thus have a macroprudential impact. These relate to (i) inaccurate valuation of financial instruments, (ii) possible volatility and illiquidity in times of stress (particularly for financial instruments classified in Levels 2 and 3), and (iii) inadequate reflection of underlying risks in the prudential framework.

Available data also reveal that the relative importance of financial instruments classified in Levels 2 and 3 varies significantly across banks and that there is substantial heterogeneity in the underlying portfolios, instruments and models associated with those instruments. With that in mind, policy

[1] The International Financial Reporting Standards define "fair value" as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". Financial instruments with a fair value that is directly observable in the market are classified in Level 1. Where the fair value is not observable but can be determined using observable inputs, financial instruments are classified in Level 2. And where the fair value of financial instruments is determined using significant unobservable inputs, those instruments are classified in Level 3.

[2] The cut-off date for the contents of this report was 18 December 2019. Consequently, all references to the European Union include the United Kingdom, which was still a member of the EU at that point.

European Systemic Risk Board
Directorate General Communications, Global Media Relations Division
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, e-mail: media@esrb.europa.eu, website: www.esrb.europa.eu

responses should focus on (i) increasing transparency through improved disclosure, (ii) making full use of the mandates assigned to auditors, accounting enforcers and microprudential supervisors, and (iii) promptly incorporating the Fundamental Review of the Trading Book into the EU's prudential framework.

For media queries, please contact William Lelieveldt, tel.: +49 69 1344 7316.

European Systemic Risk Board
Directorate General Communications, Global Media Relations Division
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, e-mail: media@esrb.europa.eu, website: www.esrb.europa.eu