Financial Stability Institute

BANK FOR INTERNATIONAL SETTLEMENTS

Policy Panel:

What macroprudential Framework for Europe?

FERNANDO RESTOY

Financial Stability Institute, Chair

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Macroprudential policy for the European banking system

- Most key current structural challenges are not typical macropru issues (NPLs, low profitability, overcapacity..).
- ...no generalised need to adopt now substantive macropru actions in either direction (at least at the euro area level)
- However, extremely accommodative monetary conditions may eventually generate financial stability risks. Macropru policy should be ready to react if and when needed.
- But first need to strengthen the macroprudential framework:
  - Availability of instruments
  - Allocation of responsibilities
  - Coordination across policy domains
  - Risks of circumvention (foreign institutions and non-banks)

Main features of the current EU macroprudential framework

- Limited toolkit: essentially only capital-based measures (for banks) are recognized in EU regulations (more freedom at the national level)
- Macroprudential toolkit for non-banks even more limited (ESRB, 2016)
- Cross-border coordination addressed via reciprocity (but evidence of cross-border spillovers so far limited, Buch and Goldberg 2017)
- Decentralized system: Initiative rests with domestic authorities
- Asymmetric system: ECB can only top-up domestic decisions
- ECB works on the basis of separation principle (no-objection procedure):
  - Strong for micropru
  - Weaker for macropru

Empirical evidence on macroprudential policies – the financial cycle

- There are important differences between the financial and business cycles: financial cycles are longer and sharper than business cycles (see eg, Claessens et al., 2012)
- But the financial and business cycles are correlated (e.g., Drehman et al, 2012) and recessions coinciding with the contractionary phase of the financial cycle are especially severe (Claessens et al, 2012)
- Financial cycles vary across countries, with some cluster of countries in Europe exhibiting highly synchronized financial cycles (over 75% concordance rate of financial cycles for BE, UK, SE, FI, ES and IE, Schueler et al, 2015)

Empirical evidence on macroprudential instruments – effectiveness

- Macroprudential instruments work well to increase the resilience of the financial system – the "pru" objective
- They also have an impact on the financial cycle – the "macro" objective (see eg, Lim et al, 2011; Cerruti et al, 2016)
- Instruments that operate via quantitative restrictions (eg, LTV, DTI, exposure limits) rather than via internal pricing (capital buffers, changes in risk weights) are more effective at smoothening the financial cycle (see eg, Borio, 2014)
- Among non-capital measures, DTI is generally among the most effective, as less pro-cyclical than others, such as LTV (see eg, Kuttner and Shim, 2013)
- Macroprudential instruments work symmetrically, but are more effective in restraining upswings, as their release in downturns is no substitute for lack of demand (see eg McDonald, 2015; Cerruti et al, 2016)
- The Spanish experience with dynamic provisioning is broadly consistent with this, but provisions were more effective in mitigating the downturn than limiting the boom (see eg, Jimenez et al, 2017)

Empirical evidence on macroprudential policies – In Sum

- Strongly supports the addition of other (non-capital based) policy instruments (DTI, DSTI, less so LTV) in the EU macroprudential regulation. Those have already been widely used elsewhere (e.g. Korea, Canada, Brazil, New Zeeland, Sweden, also The Netherlands…)
- Supports symmetric macroprudential regimes
- Also somewhat supports decentralization (financial cycles are not identical across countries)
- Yet, synergies with other centralized policies (Monetary, micropru) may put a limit to decentralization
- …but only if the separation principle is not taken rigidly

Macroprudential versus the other policy domains in the euro area/EU: a rigid separation?

- The policies' objectives (for MP, micropru and macropru) are interrelated:
  - financial and business cycle are correlated
  - financial stability can be affected by both macropru and micropru developments
  - …and by monetary dynamics
- The policy instruments often coincide:
  - interest rates drive both the financial and business cycles
  - Many macro-tools (capital add-ons, leverage ratios…) are also micro-pru tools.
  - …and Pillar 2 policies do have macro implications (e.g. Pillar-2 Guidance) and can formally be used for macropru purposes (CRD Art 97-98).
- Therefore: We need sufficient coordination among the policy areas

  (The objectives-instruments system of equations cannot be solved recursively)
- Take the separation principle pragmatically. Role of the Governing Council is key.

Implications for the EU macroprudential framework

- Objectives: increase effectiveness, favour coordination, respect the deep legal and philosophical constraints
- Keep decentralisation: national authorities should keep the initiative (at last until the national financial cycles become more synchronised)
- Enhance the ECB ability to smoothen the euro-zone financial cycle and ensure cross-country consistency of all macropru actions.
  - Allow ECB to use non-capital-based measures
  - Allow ECB to also loosen national actions
  - Seek ways to limit leakages by the operation of non-banks (non-capital measures help)
  - ..and the ECB should be pro-active in using its macro-pru powers.
- Improve communication:
  - More emphasis on consistency of policy actions taken in different policy domains
  - Work towards defining a more explicit macropru policy target

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