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The New Macro-prudential Policy Framework in the EU: the ESRB's Flagship

On 3 March 2014, the European Systemic Risk Board's (ESRB) published the Flagship Report and Handbook on Operationalising Macro-Prudential Policy in the Banking Sector. The Flagship Report offers a **first overview** about the new **EU common policy framework** and the Handbook provides **a guide to help** macro-prudential authorities. This is an important step towards clarifying the macro-prudential framework in the EU after the creation of the ESRB in January 2011.

Main issues:

- Macro-prudential policy is the use of prudential tools to mitigate systemic risks. This policy affects the banking sector as it can impose higher capital buffers and liquidity buffers among other things. Macro-prudential policy is aimed at mitigating systemic risks and ensuring financial stability in the whole financial sector (as opposed to micro-prudential supervision which is aimed at preserving stability of individual financial entities). There is a wide variety of tools to implement this policy, among other, capital buffers, liquidity buffers and large exposures restrictions.
- The **strategy** proposed consists in the following steps: (i) specifying **intermediate** macro-prudential **objectives** – for instance preventing or mitigating risks such as excessive credit growth and excessive leverage, maturity mismatch and liquidity risk; excessive exposure concentration in a particular sector and misaligned incentives; (ii) mapping these objectives into **key indicators** , such as credit-to- GDP gap; housing credit and housing prices; structural funding ratio (e.g.: the net stable funding ratio; size, complexity, substitutability and interconnectedness of systemically important financial institutions); (iii) applying **guided discretion** - the ESRB reminds that benefits from implementing a policy are not visible and long-term but costs are visible and short-term - and (iv) **choosing the adequate instruments** - such as the counter cyclical capital buffer, the systemic risk buffer, liquidity charges, larges exposure restrictions and capital surcharges - to achieve the final purpose of financial stability.
- The **process for implementing** macro-prudential policies encompasses four stages:
  i. **Risk identification and assessment**. A methodology for choosing appropriate indicators, such as the ones enumerated in the previous paragraph, and establishing indicative thresholds for them.
  ii. **Instrument selection** and **calibration**. There are five instruments: (i) capital buffers; (ii) limits to the loan-to-value (LTV) and to the loan-to-income (LTI); (iii) liquidity ratios (NSFR); (iv) concentration risk avoidance and (v) global systemically important institutions (GSIIs) requirements.

iii. **Implementation and communication**. Interaction with other policies should be assessed – i.e.: micro-prudential, monetary and/or fiscal. A good communication and an explicit governance of macro-prudential policy are of utmost importance to manage expectations and for accountability.

iv. **Evaluation.** The impact of the instruments should be compared with the achievement of the objectives they were selected for. **Cross-border** and domestic results have to be analyzed.

Instruments

- There are three kinds of instruments:
  - Instruments **under CRD**: (1) the countercyclical capital buffer (CCB); (2) the global systemically important institutions (G-SII) buffer; (3) the other systemically important institutions (O-SII) buffer; (4) the systemic risk buffer (SRB); and (5) macro-prudential use of Pillar 2.
  - Instruments **under CRR**: (a) *National flexibility measures* – they allow national authorities to enforce stricter prudential requirements - (b) and real estate-related instruments, including sectoral risk weights
  - **Other instruments** under **national** legal frameworks: (i) borrower-based lending limits – i.e.: loan-to-value (LTV), loan-to-income (LTI), debt service-to-income (DSTI) and loan-to-deposit (LTD) limits – (ii) a leverage ratio built on national law.

Next Steps for authorities

- **To do's for macro-prudential authorities**: (1) developing a policy strategy and a communication strategy; (2) promoting adequate coordination mechanisms with micro-prudential authorities and (between EU macro-prudential authorities; (3) supporting efforts to assess liquidity instruments and (4) improving data availability, comparability and quality.

Assessment:

- A **homogeneous framework** at EU level represents a step in the right direction. This is an important piece to clarify competences and the institutional framework.
- An **appropriate balance between national and European institutions** is a must. Even, if macro-prudential powers still remain under national sovereignty, national authorities should work within the ESRB framework. This is understandable as cycles are not synchronized and national authorities have to deal with national specificities.
- **Share of roles in the banking union**. Under the banking union, the ECB in its role of single supervisor will be able to adopt macro-prudential decisions concerning the European law while the national competent authority will be autonomous to adopt decisions on particular instruments regulated in national laws. Moreover, the ECB will act asymmetrically as it can toughen the decision adopted by the national authority but it cannot ease it.
- **The creation of a macro-prudential authority** for the banking union should not be dismissed.

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