bruegel

Written evidence for the Public Hearing on the Review of the EU Macro-Prudential Framework by the European Commission

Dirk Schoenmaker, Bruegel

7 November 2016

Key challenges of macro-prudential policy

Design principles

For the organisational framework of macro-prudential policy in the EU, we develop the following design principles:

A. Macro-prudential should be able to override micro-prudential, as the stability of the system is more important than that of individual institutions;
B. Macro-prudential should be consistent EU-wide to avoid cross-border leakages;
C. Macro-prudential should be applied system-wide to avoid cross-sector arbitrage;
D. A few policy instruments should cover the key risks to avoid multiple, potentially conflicting, instruments.

A. Macro-prudential first

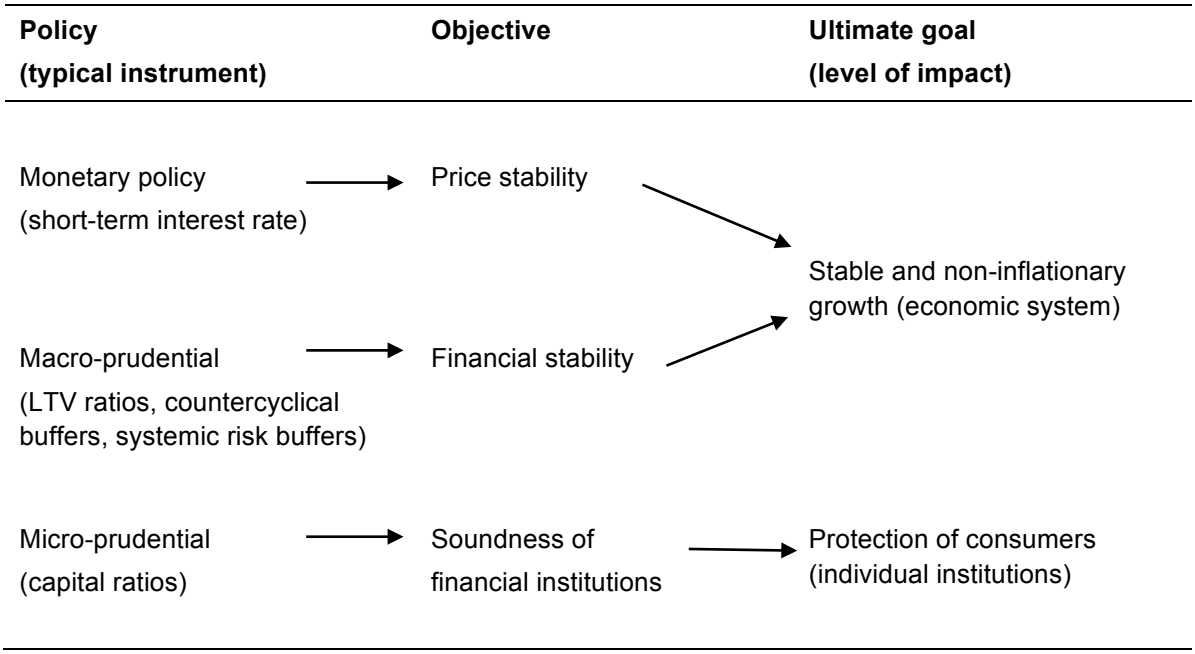
Macro-prudential supervision is the missing link in the broader monetary and financial policy framework. The global financial and euro sovereign crises showed that the financial system as a whole matters and that the unravelling of risk has endogenous feedback loops (Brunnermeier et al, 2009).

Figure 1 shows the new policy framework and places macro-prudential supervision in the middle of monetary policy and micro-prudential supervision. Macro-prudential supervision operates at the level of the financial system and is concerned with the impact on the wider economy. Asia learned its lesson after its own crisis in the late 1990s, and introduced macro-prudential policies earlier. Hong Kong, for example, has adopted an aggressive loan-to-value policy, under which the Hong Kong Monetary Authority reduces the loan-to-value ratio for new mortgages when house prices are rising too fast.

How to strike the right balance between macro-prudentialism and micro-prudentialism? Several authors argue that macro stability should have priority over micro soundness (Schoenmaker, 2014; Tucker, 2014). Until recently, the prevalent approach to financial stability implicitly assumed that the system as a whole can be made safe by making individual financial institutions safe. But now it is widely agreed that this idea, which was at the basis of original Basel banking supervision, represents a fallacy of composition. The fallacy of composition (Brunnermeier et al, 2009) derives from the fact that, when trying to make themselves safer, financial institutions can behave in a way that collectively undermines the stability of the system. Selling an asset when the price of risk increases may be a prudent response from the perspective of an individual financial institution, but if many financial institutions act in this way, the asset price will collapse, forcing financial institutions to take yet further steps to rectify the situation. The responses of the financial

institutions themselves to such pressures lead to generalised declines in asset prices, and enhanced correlations and volatility in asset markets (Shleifer and Vishny, 2011). Insofar as they neglect these general equilibrium effects, micro-prudential policies can be destructive at the macroeconomic level.

Figure 1: Policy framework for the financial and economic system



Source: Based on Schoenmaker and Wierts (2016).

Borio (2014) argues that macro-prudentialism stands for an intellectual orientation or lens through which the task of achieving financial stability is understood. Prudential tools should be designed through a macro lens instead of the prevailing micro lens.

Yet, the EU's approach to prudential supervision is predominantly micro-based. The EU Directives and Regulations for the prudential regulation of the various sectors (banking, insurance, securities) contain a detailed list of micro-prudential instruments. Only recently, a few macro-prudential instruments were added on a narrow sectoral basis (e.g. countercyclical and systemic risk buffers in the CRDIV/CRR package for the banking sector). We recommend the European Commission to adopt a comprehensive approach in macro-prudential supervision:

- By providing the relevant bodies with sufficient macro-prudential powers, which can override micro-prudential concerns if and when needed (see Sections B and C);
- By incorporating the necessary instruments in the relevant Directives and Regulations on a system-wide basis (see Sections C and D).

B. Strong EU/Euro-area coordination needed

The single market in financial services has promoted strong cross-border linkages in the EU financial system. A genuine single market for financial services develops when (large) financial firms can provide financial services across the EU. Table 1 illustrates the segmentation of large European banks and insurers. Both types of firms conduct a large part (23 percent and 31 percent respectively) in the rest of the Europe, which is evidence of a deep single market. Because of these strong cross-border linkages across the EU, macro-prudential measures implemented in one country will have cross-border leakages to other countries. This requires appropriate coordination (see Section C. on the role of the ESRB).

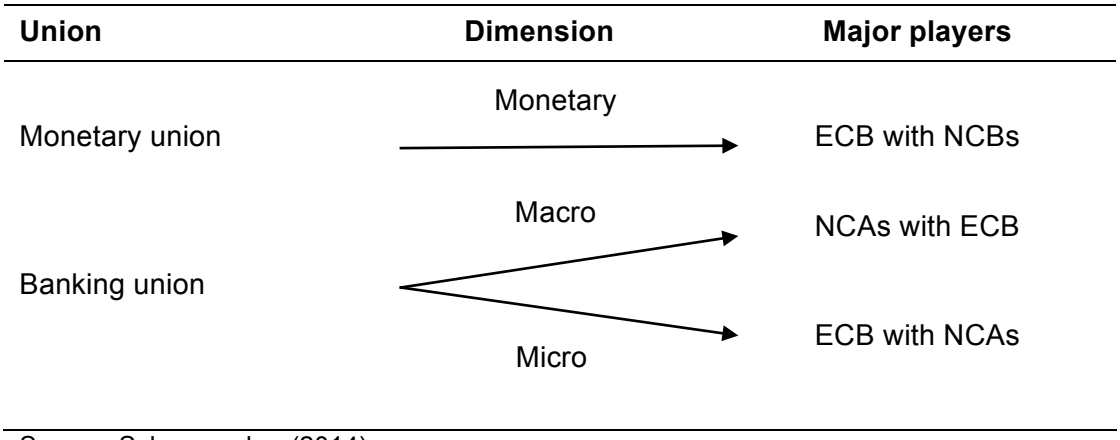
Table 1: Geographical segmentation of top 25 banks and insurers in EU, 2015

	Home	Rest of Europe	Rest of World
Top 25 banks	54%	23%	23%
Top 25 insurers	41%	31%	28%

Source: Schoenmaker (2016). Note: The geographical segmentation is calculated by assigning the assets per bank / gross written premium per insurer to the classes home (domestic), rest of Europe and rest of the world (non-Europe). Calculations are made on a weighted average basis.

Special considerations apply to the euro area in the presence of the monetary and banking union. Macro-prudential policy is even more important in a monetary union. With a 'one-size-fits-all' monetary policy, proactive macro-prudential policies are needed to address financial imbalances at the country level. While there is clear evidence that the financial cycles differ at the country level (Merler, 2015), there is no consensus on the appropriate level of coordination. Figure 2 depicts the current division of powers. In monetary and supervisory policy, the European Central Bank (ECB) takes the lead with some contributing role for national central banks (NCBs) and national competent authorities (NCAs). In contrast, in macro-prudential policy the NCAs have the first say, with the ECB in a secondary role. The SSM Regulation contains the legal basis for micro-prudential (Article 4) and macro-prudential (Article 5) supervision.

Figure 2: Policy framework for the euro area



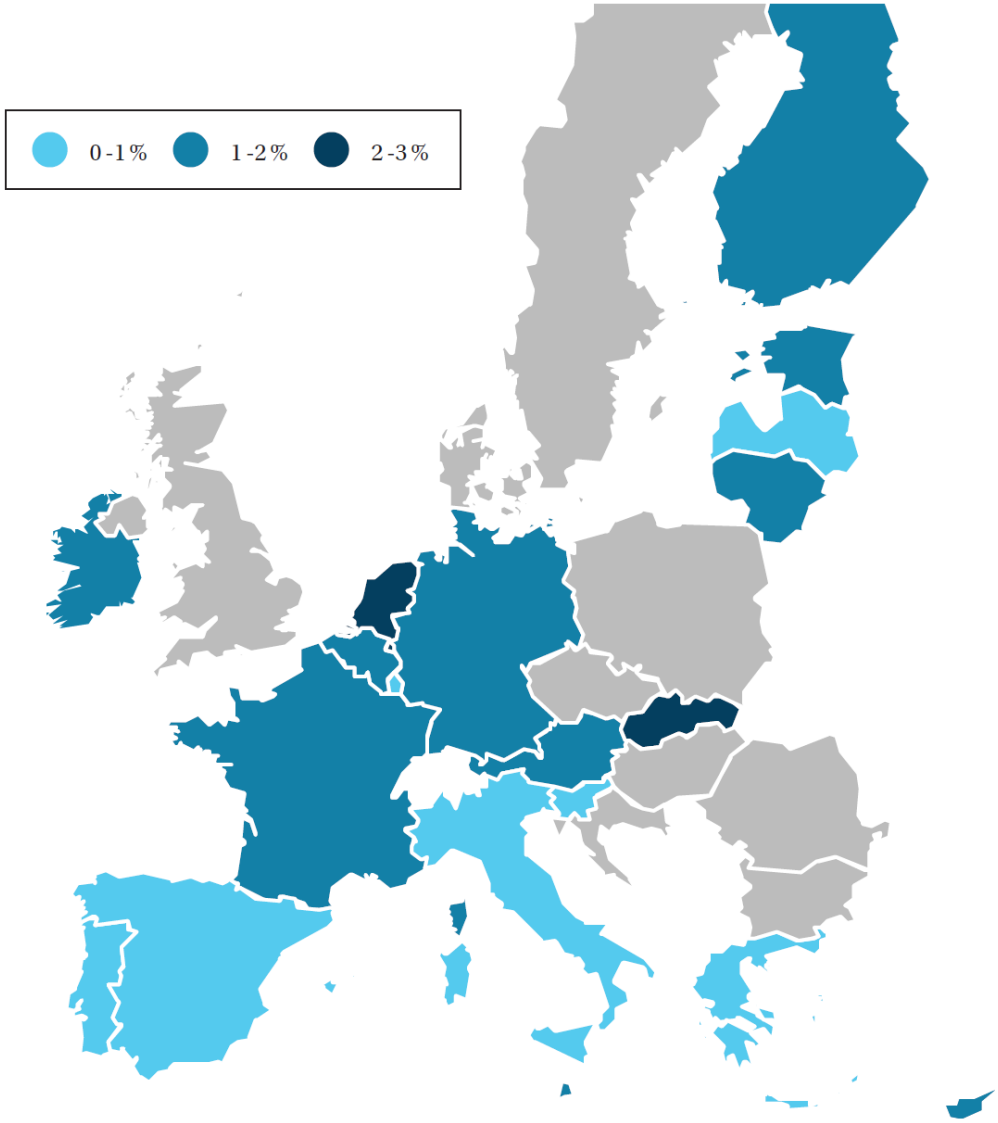
Source: Schoenmaker (2014).

Sapir (2014) and Schoenmaker (2014) argue for a strong role for the ECB. If too much is left to the national level, emerging financial imbalances might go unchecked in some countries. There is also a risk of inconsistent application of macro-prudential tools, while there are strong cross-border stability effects within a monetary and banking union. Finally, a consistent policy framework for a broader financial union suggests the alignment of the various policy tools at the same level. As discussed in Section A., macro-prudential concerns may sometimes dominate micro-prudential concerns. This macro-override is only possible if the two policies are executed at the same level.

An example of a lack consistency is the application of systemic risk buffers within the banking union. National competent authorities (NCAs) retain a separate competence on the application of macro-prudential buffers, comprising systemic and countercyclical buffers. The systemic risk buffer is an additional capital charge for systemically important banks to address the 'too-big-to-fail' issue. The Financial Stability Board has started this process with the suggestion of additional loss-absorbing requirements for G-SIBs. In addition, Articles 131 and 133 of the CRD IV empower NCAs to designate other systemically important institutions (also known in Basel parlance as domestic systemically important banks, or D-SIBs) and apply to them a capital surcharge. Figure 3 shows the applied systemic risk buffers, illustrating the differences in toughness among NCAs.

Most northern member states generally apply higher systemic buffers of up to 2 or 3 percent, while southern member states (except for Cyprus and Malta) and Latvia apply low systemic buffers of up to 1 percent. Two countries, Italy and Latvia, have set the domestic systemic buffer even at 0 percent

Figure 3: Domestic systemic buffer requirements across the banking union (fully loaded as of 2019)



Source: Schoenmaker and Véron (2016).

While national authorities have the primary responsibility for such macro-prudential requirements (Article 5.1 of the SSM Regulation), the ECB has the ability to set more stringent requirements (Article 5.2). So far, it appears that the ECB has chosen to not use this option, perhaps to avoid opening a new front in its already complex relationship with national central banks and other NCAs. Nevertheless, it appears desirable that systemic buffer requirements should be more consistent across the banking union area at some stage. Meanwhile, the variation of macro-prudential stances in different countries is bound to generate perceptions of unjustified differential treatment.

To put micro- and macro-prudential supervision on an equal basis within the banking union, we recommend aligning Articles 4 (micro) and 5 (macro) of the SSM Regulation. In particular, we suggest that Article 5 gives similar powers, as in Article 4, to the ECB to take the initiative, in cooperation with the NCAs. This cooperation is important as the input of NCAs is needed for the actual application of macro-prudential tools, as financial conditions can differ across countries. But by giving the leading role to the ECB, a consistent framework and timely application of that framework can be guarded.

C. System-wide reach by ESRB

There is also strong evidence of cross-sector linkages. Nevertheless, macro-prudential policy instruments are developed in silos. The Basel policy response, for example, with a countercyclical capital buffer is only directed at banks. By contrast, loan-to-value (LTV) ratios are borrower based and can be designed so that they apply to all financial institutions that grant mortgages (see D. below). Sectoral regulations intensify the boundary problem (Goodhart, 2008). When regulation for one sector is tightened, business will shift to other sectors with less or no requirements. Cizel et al (2015) find evidence for the cross-sector substitution effects of macro-prudential policy.

At the EU level, the ESRB has a legal responsibility for macro-prudential oversight and the prevention and mitigation of systemic risks to the EU financial system. It can give warnings and recommendations. The composition of the ESRB reflects the need for a system-wide approach. In addition to the national central banks and supervisors of the EU, the three sectoral European Supervisory Authorities as well as the ECB are full members of the ESRB. The ESRB is thus an ideal platform to discuss and analyse macro-prudential issues, because of its cross-border and cross-sector reach.

We recommend strengthening the visibility and the profile of the ESRB with a Managing Director (ASC, 2013). The Managing Director would execute the policies set by the General Board of the ESRB. The stronger profile would reinforce the message that the ESRB has an overarching perspective regarding the EU financial system. This perspective is broader than the ECB's remit in micro- and macro-prudential supervision, which is confined to the banking sector in the banking union countries. A Managing Director for the ESRB would also highlight the ESRB's 'independence' from the ECB, where it is located.

D. Addressing key systemic risks

It is important that the EU arrangements for macro-prudential policy are capable of addressing the key systemic risks. We mention three systemic risks and related instrument. The first is the building up of financial imbalances through credit growth.

The countercyclical capital buffer is meant to reduce the amplifications in the financial cycle. The second is the moral hazard caused by too-big-to-fail financial institutions. The systemic risk buffer in the CRDIV/CRR already applies to large systemic banks. Following the introduction of similar systemic risk charges for globally systemically important insurers by the Financial Stability Board, we recommend to include systemic risk buffers for insurers in the Solvency II Directive. A third key systemic risk is in the housing sector, which we discuss in more detail. Most financial crises originate from a housing price boom – bust. Moreover, Jorda, Schularick and Taylor (2015) show that there is a link between loose monetary conditions, credit growth, house price booms, and financial instability. The current low interest rate environment makes the financial system thus particularly vulnerable to a housing price boom – bust, as the low interest rates make mortgages more affordable to households. The (excess) liquidity from Quantitative Easing might thus find its way into housing, leading to housing bubbles.

There is evidence that in the run-up to the recent housing busts, banks lowered lending standards fuelling the prior housing booms. High loan-to-value (LTV) ratios indicate loose credit standards. A case in point is the higher LTVs in the run-up to the 2007 housing bust in Ireland. While in 2005, only half of first-time buyers had LTV rates above 90 percent, with very few above 100 percent; these numbers went up in 2005 and 2006. By then, two-thirds of mortgages to first-time buyers had LTV rates over 90 percent and one-third over 100 percent (Honohan 2009).

LTV ratios are an important macro-prudential instrument to contain housing prices. However, the EU financial legislation does not contain this instrument. We recommend incorporating the LTV ratio as macro-prudential instrument in the relevant EU directives and regulations across the financial system (in particular for banks in the CRDIV/CRR and insurers in Solvency II). The ESRB could then give guidance in the form of a warning or recommendation on the application of the LTV buffer in one or more countries to the relevant macro-prudential authorities.

References

Advisory Scientific Committee (ASC) (2013) *The consequences of the single supervisory mechanism for Europe's macro-prudential policy framework*, Report No. 3 of the Advisory Scientific Committee of the European Systemic Risk Board

Advisory Scientific Committee (ASC) (2014) *Allocating Macro-Prudential Powers*, Report No. 5 of the Advisory Scientific Committee of the European Systemic Risk Board

Borio, C. (2014) '(Too) great expectations for macro-prudential?', Central Banking Journal 41, 79-85

Brunnermeier, M., A. Crockett, C. Goodhart, A. Persaud, and H. Shin (2009) 'The Fundamental Principles of Financial Regulation', Geneva Report on the World Economy, vol. 11. CEPR, London

Cizel, J., J. Frost, A. Houben and P. Wierts (2015) 'Effective Macroprudential Policy: Cross-Sector Substitution of Price and Quantity Measures', IMF Working Paper, *forthcoming*

Goodhart, C. (2008) 'The boundary problem in financial regulation', *National Institute Economic Review* 206, 48–55

Honohan, P. (2009) 'Resolving Ireland's Banking Crisis.' *Economic and Social Review* 40, 207–231.

Jordà, A., M. Schularick and A. Taylor (2015), 'Betting the house', *Journal of International Economics* 96, Supplement 1, S2-S18

Langfield, S. and M. Pagano (2016) 'Bank Bias in Europe: Effects on Systemic Risk and Growth, *Economic Policy* 31(85), 51-106

Merler, S. (2015) 'Squaring the Cycle: Financial Cycles, Capital Flows and Macroprudential Policy, Bruegel *Working Paper* No. 2015/14, Brussels

Sapir, A. (2014) 'Europe's macroprudential policy framework in light of the banking union', in: D. Schoenmaker (ed), Macroprudentialism, VoxEU eBook, CEPR, London, 161-170

Schoenmaker, D. (2014) *Macroprudentialism*, VoxEU eBook, CEPR, London

Schoenmaker, D. (2016) 'Increasing Cross-Border Insurance in Europe', Bruegel *Policy Contribution*, Brussels, forthcoming.

Schoenmaker, D. and N. Véron (2016), European Banking Supervision: The First Eighteen Months, Blueprint 25, Bruegel.

Schoenmaker, D. and P. Wierts (2016) 'Macro-Prudential Policy: From Theory to Practice', *National Institute Economic Review* 235, R50-R6

Shleifer, A. and R. Vishny (2011) 'Fire Sales in Finance and Macroeconomics', Journal of Economic Perspectives 25, 29-48

Tucker, P. (2014) 'The political economy of macroprudential regimes', in: D. Schoenmaker (ed), Macroprudentialism, VoxEU eBook, CEPR, London, 61-72