EU macroprudential policy lays emphasis on residential mortgage loans and the banking sector's structural risks

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The European Union has for about two years witnessed the conduct of macroprudential policy mainly based on EU legislation and calibrated for national circumstances. In most cases, the measures have been of a tightening nature and aimed at addressing the banking sector's structural risks and lending for house purchase. Regulatory reforms and macroprudential measures have improved the risk resilience of the bank-centred EU financial system. Work on also targeting macroprudential policy at stability risks building up beyond the banking system is at an initial stage.

The global financial crisis and the European sovereign debt crisis revealed the need to revise the regulation and improve the supervision of financial markets. Broad-based reforms resulted in the creation of institutions to maintain financial stability and the introduction of a new economic policy segment, macroprudential policy.

Macroprudential policy refers to active measures taken by the authorities with a view to preventing and mitigating systemic risks threatening the financial system.

Within the European Union, macroprudential policy is based on the Capital Requirements Directive and Regulation of the same name, which entered into force in 2014, on the Member States' national legislation and the recommendations issued by the European Systemic Risk Board (ESRB). Most EU countries have now completed the institutional arrangements for macroprudential policy, designated their respective macroprudential authorities and created a decision-making process and a macroprudential toolkit. The establishment of Banking Union led to the European Central Bank being assigned the role of macroprudential authority with powers to assess and, where necessary, apply more stringent macroprudential measures than those adopted by national authorities.[1]

The decision-making process and implementation of macroprudential policy comprise a series of different stages. Risks and vulnerabilities threatening the stability of the financial system need to be identified and addressed, as far as possible, by specifically targeted macroprudential measures. The impact and effectiveness of the measures and their potential side effects are analysed on a regular basis. The toolkit of macroprudential authorities includes both binding 'hard' macroprudential instruments based on legislation and 'soft' tools, such as warnings and recommendations.

Active macroprudential policy based on EU regulation has now been conducted for about two years.[2] Macroprudential policy implemented at national level within the EU has so far targeted mainly banks and related systemic risks. This is due to the bank-centred nature of the European financial system and legislation concerning macroprudential policy.

So far, little use has been made of cyclical tools

The EU macroprudential framework and toolkit were replenished in 2016, when the remaining Member States put in place the arrangements for a countercyclical capital buffer requirement. This is a tool aimed at addressing cyclical systemic risks and guiding credit institutions in the strengthening of their risk resilience in times of rapid credit growth. This is done by setting higher capital requirements.

Correspondingly, in a downturn, by releasing such capital buffers, credit institutions can be encouraged to maintain lending, which is supportive of economic growth. Within the EU, this additional capital requirement[3] of 2.5% at most of risk-weighted assets had been set at a level other than zero in only four countries by the end of 2016.[4]

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1. The ECB is empowered to tighten nationally implemented macroprudential measures that are based on EU legislation.
2. The European Systemic Risk Board has published reviews of macroprudential policy in the EU in 2014, 2015 and 2016. The author drew on the reviews as sources for this article.
3. The countercyclical capital buffer requirement is calculated relative to the risk-weighted amount of credit exposures to the country concerned.
4. The countries were the United Kingdom, Sweden, Slovakia and the Czech Republic, along with the non-EU country Norway. In the United Kingdom, however, the countercyclical capital buffer requirement was decreased

Experiences gained to date from the application of the countercyclical capital buffer requirement indicate that the primary risk indicator defined for assessment of the need to activate the tool appears to guide decisions less than expected.[5] An EU-wide review found no clear connection between the value of the primary risk indicator, i.e. the private sector credit-to-GDP gap, and the size of the determined countercyclical capital buffer requirement. The limited use seen so far of the countercyclical capital buffer requirement reflects most EU countries' subdued credit cycle and economic growth in recent years.

Measures addressing structural risks are common

The risk resilience of the bank-centred EU financial system was further strengthened in 2016, with the remaining Member States also completing the designation of their domestic systemically important credit institutions. The number of such systemically important institutions designated in the EU and Norway totalled 202 by the end of 2016.[6] An additional capital buffer requirement of at most 2% of total risk exposures for systemically important credit institutions, to be met either on a gradual basis or at one time, has been imposed on most of these institutions.[7]

The dispersion between the levels of additional capital buffer requirements imposed on systemically important institutions is fairly large across the EU. Part of this dispersion is accounted for by the fact that the majority of EU countries are enforcing these capital buffers gradually, by 2022 at the latest. Especially those countries in which the condition of the banking sector has been difficult in the aftermath of the financial and debt crises have made use of the opportunity offered by the legislation for a long phase-in period. The dispersion is also, in part, based on differences in the way the authorities define the degree of systemic importance for credit institutions.

On top of additional capital buffer requirements for systemically important institutions, one of the most frequently employed macroprudential tools among EU Member States is the systemic risk buffer aimed at addressing structural risks within the financial system.[8] This systemic risk buffer, normally not exceeding 5% of defined risk-weighted assets, enables mitigation of risks caused by the vulnerability of the financial system's structure to the stability of the system and the economy.[9] Compared with many other tools, the systemic risk buffer is considered flexible. For this reason, in part, the practices

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back to 0% only a few months after the decision to increase it, in response to the potential implications for financial stability of the outcome of the country's referendum on EU membership.

5. As a basis for decision-making, authorities most often also use other indicators, such as those illustrating the development of the macro economy and the credit cycle. In Finland, the relevant Ministry of Finance Decree defines the supplementary factors to be employed in decision-making.

6. A total of 14 of these institutions are also designated as global systemically important banks and are subject to an additional capital buffer of 1–3.5%.

7. The United Kingdom has imposed a capital buffer intended for systemically important institutions only on banks that are globally systemically important banks.

8. Existing legislation enables application of the systemic risk buffer in all EU countries other than Italy, Finland and the United Kingdom. Of these, at least the two latter countries are making preparations for incorporation of the systemic risk buffer into legislation.

9. Of capital buffers for domestic or global systemically important institutions and the systemic risk buffer, the highest buffer requirement is basically binding.

as to where and how the buffer is deployed and the rationale for its use differ greatly across countries. EU countries also apply the systemic risk buffer to, for example, complement and compensate for other macroprudential tools.[10]

Toolkit applicable to lending for house purchase has broadened

Apart from additional capital requirements based on EU legislation, national authorities have also made active use of various macroprudential instruments applicable to lending for house purchase and the housing markets. Macroprudential policy addressing lending for house purchase reflects structural and operational differences that have evolved over a long period of time on national housing and residential mortgage loan markets. The scope of macroprudential instruments targeting residential mortgages or the operation of housing markets varies by country, as most of these tools are based on national legislation.

About two thirds of EU countries have to date adopted a maximum loan-to-value ratio of some sort restricting the relationship between a residential mortgage and the collateral provided. Meanwhile, in about half the Member States authorities have set limits for the loan amount or debt-servicing costs relative to the borrower's income. Likewise, about half the EU countries have reinforced credit institutions' resilience to risks stemming from housing or residential mortgage loan markets by, for example, increasing risk weights for residential mortgages or through other targeted measures.

An analysis by region shows that macroprudential tools addressing lending for house purchase are most frequently used in the Nordic and smaller Central European countries. Southern European and large Central European countries, meanwhile, have barely taken any macroprudential measures aimed at lending for house purchase.

Residential real estate lending also took centre stage in the EU's single macroprudential policy in 2016, as the European Systemic Risk Board warned eight EU Member States regarding medium-term housing market vulnerabilities and potential systemic risks. These first warnings published by the ESRB were related to household debt and also to the high level of, or rapid increases in, housing prices in respect of most countries.[11] All the countries that received the warning had applied at least one of the above macroprudential instruments addressing lending for house purchase, but the ESRB deemed the measures possibly inadequate.

Macroprudential policy must be ready to respond rapidly to changes

Regulatory reforms following the financial crisis and active macroprudential policy

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10. For example, the Czech Republic and Denmark employ the systemic risk buffer for mitigating risks and vulnerabilities caused by systemically important banks.
11. The warning was issued to Belgium, the United Kingdom, Austria, Luxembourg, Sweden, Denmark, the Netherlands and Finland, in respect of which – except for the two last-mentioned countries – particular attention was drawn to the level of, or rise in, house prices.

pursued for about two years have strengthened the European financial system and improved banks' loss absorbing capacity, in particular. National authorities of most EU countries already have in place established processes and tools for the practical implementation of macroprudential policy applicable to the banking system, based on EU legislation and calibrated for national circumstances.

The European authorities for macroprudential oversight, the ECB and ESRB, have also established their position in macroprudential policy. Looking ahead, the need for cross-border cooperation between the authorities will be highlighted in order to ensure policy effectiveness amid deepening financial integration. On the basis of experiences gained from implementation of the policy, the European Commission is currently assessing[12] the type of development or reform needs there may be in macroprudential regulation, tools and decision-making processes.

Work on analysing and preventing systemic risks and vulnerabilities beyond the banking sector is at an initial stage. The financial sector is in a process of ongoing change, and macroprudential policy should seek to also mitigate the implications of stability risks building up outside of the traditional banking sector. The responsive capacity of European macroprudential policy and the consistency of regulation and supervision may also be put to the test in the near term by, for example, financial system changes resulting from the departure of the United Kingdom from the EU. With macroprudential policy consolidating its role as an economic policy segment, it is important for the policy to retain its capacity to rapidly respond to a changing operating environment.

Tags

macroprudential tools, financial stability, EU, macroprudential policy

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12. See. the European Commission's autumn 2016 consultation document 'Review of the EU Macro-prudential framework'