

# Requirements for macroprudential policy

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# Importance

- ◆ One important lesson from the financial crisis is that, alongside monetary policy and microprudential supervision, macroprudential policy is also needed in order to maintain financial stability.
- ◆ Particularly relevant in a single currency area such as the euro area where monetary policy cannot be tailored to the financial and economic circumstances in the individual member countries.
- ◆ Further emphasised by the acute debt crisis in the euro area since 2010.

# What is it?

- ◆ Rather than focusing primarily on individual institutions, macroprudential policy targets developments that could threaten the stability of the entire financial system.
- ◆ Structural dimension (interaction between financial institutions and their environment) and cyclical dimension (dynamism with which disequilibria can accrue over time).
- ◆ On the one hand macroprudential policy focuses on seeking to boost the financial sector's resistance to stress and on the other hand on preventing imbalances that constitute risks to the financial system.

# Outline presentation

- ◆ In Europe: as ESRB has limited powers focus should be on national level
- ◆ How to arrange macroprudential policy at national level: requirements
- ◆ Some examples: UK and the Netherlands

# European Systemic Risk Board

- ◆ Operational since the start of 2011.
- ◆ Responsible for macroprudential supervision of the financial system in Europe. Its aim is to help prevent or reduce systemic risks in the EU.
- ◆ Can issue warnings and make recommendations to Member States, European Supervisory Authorities, national supervisors, the EU as a whole, or to the European Commission if they relate to relevant EU legislation.
- ◆ ESRB recommendations are not binding: 'comply or explain'.

# ESRB: structure

- ◆ General Board: 37 members with voting rights: the President and Vice-President of the European Central Bank (ECB), 27 governors of the NCBs, a representative of the European Commission, the chairs of the three European Supervisory Authorities (EBA, ESMA and EIOPA), the chairs and two vice-chairs of the Advisory Scientific Committee and the chair of the Advisory Technical Committee.
- ◆ 28 members without voting rights: in addition to the President of the Economic and Financial Committee, each of the 27 EU member states delegates a representative from its national supervisory authority.

## Buiter (2009):

- ◆ “membership ... enough to run a small football league. This is not a body that will do anything useful. ... It is astonishing to have .... a European Systemic Risk Board that does not find a place in the key decision-making bodies for the fiscal authorities – a place that ought to be at least as significant as that of the central banks. ... Central banks have neither the technical knowledge, nor the tools and instruments nor the legitimacy to dominate. ...Accountability is, defined purely in terms of reporting obligations, with no sanctions or punishment available to be imposed on the ESRB should their performance not be up to snuff.”

# Our view (I):

- ◆ We believe the limits of powers and lack of concrete instruments are more deserving of criticism.
- ◆ Financial integration and external effects of national macroprudential policy are good reasons for the presence of a macroprudential authority at European level.
- ◆ However, there is currently no political support in the major EU member states for transferring any sovereignty to the ESRB (Buckley and Howarth, 2010).
- ◆ As a result, the instruments available to the ESRB are limited. Moreover, ESRB recommendations require the support of two-thirds of the members of the General Board.



## Our view (II):

- ◆ ESRB is to make the most effective possible use of the tools that are available to it. ESRB can exert more pressure on authorities to respond to risks identified and ESRB policy recommendations can definitely have an impact.
- ◆ Communications will play a major role.
- ◆ Clear that primary responsibility for macroprudential policy remains with the EU Member States, and that the effectiveness of European macroprudential policy stands or falls with the way in which macroprudential policy is structured at a national level.

# Requirements of macroprudential policy (I)

- ◆ *Objectives*: protect financial stability, which we define as the ability of the financial sector to efficiently allocate financial resources to expenditure, to manage risks and to absorb external shocks, while not being a source of disruption itself.
- ◆ *But*: largely determined outside the domain of macroprudential policymakers and by exogenous shocks and other policy fields.

## (II)

- ◆ Financial stability is also highly dependent on microprudential supervision (in other words, whether an individual institution is able to meet its commitments), conduct supervision (i.e. whether transactions arise in a transparent market), monetary policy (i.e. whether the general level of prices is stable), fiscal policy (i.e. whether certain financial products are encouraged by tax facilities) and how competition is supervised (i.e. the discipline to which financial institutions are subjected).
- ◆ Macroprudential policy is a narrower concept than financial stability and only covers those instruments primarily targeting financial stability.

## (III)

- ◆ Maintaining a clear distinction between these policy areas and delineating the scope of macroprudential policy help to achieve a clear division of responsibilities.
- ◆ Policy should be based on *Macroprudential analysis* that seeks to identify the principal risks in the financial system in terms of their probability, impact, and time horizon.
- ◆ *Instruments* focus primarily on financial stability and act directly on financial relationships within economic sectors (LTV), at financial institutions (cyclical capital requirements for banks) or in financial markets (margin requirements) or indirectly influence behaviour (communications)

## (IV)

- ◆ A recent IMF survey found that the fifteen European supervisory authorities questioned had varying preferences regarding macroprudential instruments. Their answers to questions about the instruments they would wish to include in their arsenals showed that LTV limits, counter-cyclical capital requirements, margin requirements, restrictions on profit distributions and capital surcharges for system-relevant banks enjoyed greatest popularity.

## (V)

- ◆ *Scope* should cover all potential sources of financial instability. Must also extend to institutions or markets that are not subject to microprudential or conduct supervision. One lesson to be learned from the crisis is that it is precisely in the interaction between regulated financial institutions and non-regulated or less well-regulated financial markets that systemic risks can arise. The statutory powers available to the macroprudential authority need to reflect this.

# Institutional structuring of macroprudential policy (I)

- ◆ Arguments in favour of granting a macroprudential mandate to an *independent authority*: tail risks, uncertainty, benefits are often not quantifiable or visible, and reduced borrowing capacity.
- ◆ Evidence that CBI is negatively related to financial instability (Klomp and De Haan, 2010)

# Institutional structuring of macroprudential policy (II)

- ◆ Arguments in favour of assigning a key role to the central bank: enjoys a high degree of independence and has the required expertise and is the ultimate source of emergency funding in the event of financial instability.
- ◆ Arguments in favour of committee structure: can promote the exchange of information and policy coordination among the various bodies that influence financial stability. In this way a committee structure can help achieve cooperative policy solutions, also with regard to the use of policy instruments not primarily focused on financial stability.



# Institutional structuring of macroprudential policy (III)

- ◆ *Accountability obligation* requires (but is not the same as) transparency. Performance cannot be properly assessed if it is not sufficiently clear what a macroprudential authority has done, and why. An important instrument in this respect is the publication of periodic Financial Stability Reviews.
- ◆ Essence of accountability is that once a principal (such as the legislator) delegates a particular task to an agent and gives the agent instruments to perform this task, the agent must be held accountable for achieving the objective. In case of negative assessment, the principal can intervene.

# Institutional structuring of macroprudential policy (IV)

- ◆ Major difference between accountability for monetary policy and accountability for macroprudential policy as objective of macroprudential policy (i.e. financial stability) is less easy to define than the objective of monetary policy (i.e. price stability). Therefore: focus on policy processes and underlying analyses instead of on results.

# Macroprudential policy in UK (I)

- ◆ Financial Policy Committee (FPC), which will report directly to the Court of Directors, the governing body of the Bank of England ('BoE'). The FPC will be chaired by the Governor of the BoE. The Ministry of Finance ('HM Treasury') will be represented on the committee, but will not have voting rights.
- ◆ Minister of Finance has discretionary powers to send a mandate letter to the FPC, to which the FPC must respond.
- ◆ FPC does not itself have any responsibility for performing supervision.

# Macroprudential policy in UK (II)

- ◆ FPC has four instruments or means of exerting pressure in order to address systemic risks: (i) public communications, including warnings; (ii) exerting influence on macroprudential policy at a European and global level; (iii) making (public) recommendations to authorities other than the microprudential and conduct supervisors; (iv) issuing direct instructions to microprudential and conduct supervisors.
- ◆ FPC is required to publish a semi-annual report. FPC meeting reports must be published within six weeks. Instructions must also be sent to the Minister of Finance, who can then send them to Parliament.

# Proposal for Netherlands

- ◆ Vest responsibility for macroprudential policy in DNB and provide statutory mandate.
- ◆ Coordinating committee with representatives of the Ministry of Finance, the Netherlands Authority for the Financial Markets and the Netherlands Competition Authority, among others.
- ◆ Proper provisions must be in place to ensure compliance with the accountability obligation. This can be done by making DNB accountable for input and the process, but vesting ultimate political responsibility in the Minister of Finance, e.g. by granting him the authority to issue instructions.

# Proposal for Netherlands (II)

- ◆ Macroprudential policy requires a careful communications strategy and effective management of expectations.
- ◆ Setting overly high ambitions, certainly if these are not achieved, can result in disappointment both among the public and politicians.
- ◆ Therefore: start cautiously, with a gradual introduction of macroprudential instruments and, as experience is gained, an increasingly assertive use of the granted mandate. Initial steps could include giving DNB powers regarding the anti-cyclical buffer in banks' capital requirements (in accordance with Basle III) and limits on LTV ratios.

**Thank you for your attention**

