Pentti Hakkarainen: Capital-based macro-prudential instruments - what type of policy tools are needed to address macro-prudential risks in the banking sector?

Notes by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, for the panel discussion on "Capital-based macro-prudential instruments - what type of policy tools are needed to address macro-prudential risks in the banking sector?", EU Commission's Public Hearing on the Review of the EU macro-prudential framework. Brussels, 7 November 2016.

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Thank you for your invitation to speak here today in front of this distinguished audience. This review of the EU macroprudential framework is very essential work for the European Union.

In my opening remark, I would like to share with you two points on capital-based macro-prudential instruments, based on our own policy making experiences: First, effects of the said instruments are uncertain and second, processes for their usage are unnecessary complicated. These points are intertwined.

Let me start by saying that macroprudential policy is needed addition to other economic policies. It is very important that authorities have also macroprudential instruments available. We experienced in Finland in the early 1990's a severe boom and bust cycle, at a time when we did not have any such tools. Now, after the Great Financial Crisis, we have instruments and framework in place. My comments today should be perceived as suggestions for improvements only and not criticism of the framework and instruments.

- We have several capital-based instruments available via CRR/CRDIV, but in practice we have found it difficult to find an "appropriate" instrument to mitigate systemic risks related to residential real estate and household indebtedness.
- Some countries are already trying to curb acceleration of growth in prices and indebtedness, while we in Finland have been more troubled with existing levels of indebtedness and muted macroeconomic outlook.
- When banks are well-capitalized and hold voluntary buffers well above regulatory capital requirements, broad based additional capital requirements, as macroprudential tools, are less effective and more targeted measures would be more appropriate, in my view.
- Banks with high capital buffers have no need to respond to these macroprudential policy actions, and therefore the impact may either be marginal or different than what was aimed at.
- I am not sure whether the differences in banking structures and their solvency metrics were sufficiently considered when the European legislation for macroprudential policy was designed.
- I do not suggest that we would need new capital-based instruments, but the existing ones could be fine-tuned to increase some flexibility. With flexibility I do not mean that countries should use different tools to the same symptom. On the contrary, I would rather argue for less overlap between instruments.
- But, more targeted macroprudential policy via capital-based instruments could be achieved by explicitly allowing usage of CCB and SRB (countercyclical and systemic risk buffers) also to address systemic risks in specific sectors, e.g. by applying them to residential real estate loans.
- Turning to my second point, flexibility in instruments could further be enhanced by easing application criteria and simplifying decision-making procedures. However, a comprehensive assessment taking into account all relevant measures and their effects would be helpful in

informing macroprudential decisions.

- For example, article 458 is considerably more difficult and time-consuming to use than Pillar 2 instruments, which in our view should not be used as primary macro-prudential policy instrument. Therefore, removing the “pecking order” in CRR Art. 458 would be beneficial.
- On Pillar 2, I would further like to point out that several competent authorities, of which some are outside the SSM or EU, are relevant in the Nordic banking sector. Therefore, decisions on risk weights impacting capital, or using other competent authority’s tools for macroprudential purposes may be complicated, as they are not in the hands of the macroprudential decision maker.
- Conditions for using capital-based measures are not self-evident, neither are their timing nor calibration.
- When applying macroprudential instruments in practice, it is vital to know expected consequences and effects on banks, debtors and macroeconomy. Without such knowledge, policy makers cannot take into account all relevant factors when making the decisions. Afterwards, it is difficult to judge the effectiveness of the measures taken and possible needs to adjust their calibration.
- Impact analysis in general, both ex ante and ex post, is still at its early development steps. However, what we already know is that borrower based instruments (LTI/DSTI/LTV/loan amortization) are likely more efficient than capital-based measures for systemic risks I referred to in the beginning.
- Borrower based instruments are specific and targeted instruments, but politically sensitive and in public interest. Therefore, decision making of those instruments should remain at the national level.
- In a very integrated market there are, however, many ways to circumvent policy actions. Thus, reciprocity is of essence. Making reciprocity effective requires that tools available in different EU-countries are sufficiently standardized.
- Preferably, borrower based tools should be introduced into European legislation because that would ensure the availability of those instruments in each jurisdiction. At a minimum, I would see benefits in some level of EU-wide harmonization. This would be needed already for level playing field reasons, for enabling cross-country comparisons and reciprocation.
- Our challenge in applying capital-based macroprudential instruments is how to achieve a correct impact and in time. Swift, straightforward decision making process is one precondition for successful macroprudential policy going forward. However, the conduct of macroprudential policy doesn’t require only a good timing but also a careful consideration of interplay with other economic policies. As it has been pointed out in many occasions – like the IMF Seminar “Rethinking Macropolicy III; Progress or Confusion?” – we may not know exactly how to best use macroprudential instruments, but we know that we are on the right track."
- To sum up. I called for some flexibility, as systemic risks and banking structures differ from one country to another. Macroprudential policy framework was created in a way that would mitigate inherent inaction bias in unpopular decisions. Legislation could be developed further into that direction, as we need more actions and less “talking to the wind”. We in Finland have national, SSM, EU and Nordic links and procedures in place. Every measure to simplify processes and to diminish bureaucracy would be more than welcome.