Claudia Buch: Public hearing on the Review of the EU Macro-Prudential Framework – panel discussion

Statement by Prof Claudia Buch, Deputy President of the Deutsche Bundesbank, at the public hearing on the Review of the EU Macro-Prudential Framework - panel discussion, European Commission, Brussels, 7 November 2016.

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1. Overview

After the financial crisis, macro-prudential policy has been established as a new policy area with the mandate to ensure the stability of the financial system as a whole and to prevent systemic risks building up. Systemic risks in financial systems arise if distress in one institution or a group of financial institutions threatens the functioning of the entire financial system. Resilience of the financial system with regard to systemic stress thus requires buffers which take these externalities into account.

Experience with macro-prudential policies is limited though, which requires a continuous monitoring of the progress that has been made. The consultation process that has been launched by the European Commission on the macro-prudential framework is a key element of monitoring the effectiveness and efficiency of macro-prudential institutions.

Effective macro-prudential policies are particularly needed at the European level, given the close real and financial linkages between member countries of the European Union (EU). Effective macro-prudential policies require an institutional set-up with three key characteristics. First, the institutional set-up should allow tracking potential risks to financial stability. Second, it should clearly assign responsibility for the use of macro-prudential instruments. Third, it should allow for the effective coordination between institutions tasked with macro-prudential mandates. In this regard, the European Systemic Risk Board (ESRB) has a critical function. Maintaining its current strength and improving its institutional set-up, where needed, should thus be a priority.

Maintaining and strengthening the role of the ESRB gives rise to questions concerning its mandate and its role as well as the organizational structure and the institutional links with the ECB. When the ESRB was established, the ECB did not have the role of a micro-prudential banking supervisor nor did it have macro-prudential responsibilities in the banking sector. This has changed with the Banking Union and the establishment of the Single Supervisory Mechanism (SSM). Therefore, potential changes in the ESRB's organizational structure and its ties to the ECB should reflect the ECB's new role in the SSM.

Overall, the ESRB's mandate is appropriate and its role is essential in coordinating and assessing macro-prudential policies for the whole EUfinancial market. However, there are three areas in which the efficiency and effectiveness of the ESRB could improve:

1. The ESRB has a comparative advantage in analyzing and addressing macro-prudential issues that involve the cross-border and cross-sectoral dimension. Therefore, one might strengthen the ESRB's capabilities to focus on these issues.
2. The coordination and notification requirements that are in place right now are overly complex. Hence, it should be considered to establish the ESRB as a central hub for notifications concerning macro-prudential instruments that also harmonizes procedures. This may, for instance, include a single EU-wide platform for notification procedures which currently does not exist.
3. The ESRB provides a valuable platform for the exchange of experiences in macro-prudential policy making. In order to enhance this role, the ESRB could act as a hub for the ex-post evaluation of macro-prudential policies by coordinating analytical work. It could set up

dedicated working groups and ensure high-quality output by coordinating peer-reviews of the evaluation.

Successfully improving the operations of the ESRB and strengthening its capacities has two important prerequisites. First, The ESRB would need more own resources to build up independent analytical capacities mainly to identify, to propose and to coordinate joint analytical efforts, thereby reducing the current dependence on ECB's resources. Cooperation with the European Supervisory Authorities[1] (ESAs) should be intensified in order to enhance its cross-sectoral analytical capacities. Second, the ESRB needs access to relevant data and information and data sharing among members has to be facilitated.

2. Mandate and Role of the ESRB

The macro-prudential supervisory architecture of the EU was established right after the financial crisis, while the macro-prudential architecture of the Euro Area was significantly overhauled with the establishment of the Banking Union in 2014. At the EU level, the ESRB has been in place as an integrated financial supervisor for macro-prudential supervision since 2011. The ESRB's aim is to identify systemic risks in the financial system and to propose measures to eliminate them, employing warnings and recommendations, which are subject to a 'comply or explain' mechanism. Mandates for macro-prudential policies lie at the national level. However, with regard to specific macro-prudential measures, the ECB has asymmetric intervention powers: according to Article 5 of the SSM Regulation, the ECBmay – after consultation with the national supervisory authorities – tighten macro-prudential measures enshrined in the CRD IV but not ease them.

Cross-border and cross-sectoral surveillance

Given the importance of national risk factors and institutional specificities that affect systemic risks, surveillance of systemic risk has a strong domestic component. Thus various authorities, in particular central banks, which traditionally maintain capacities for a holistic analytical view combining cross-sectoral views with micro- and macroeconomic analysis, contribute to macro-prudential surveillance through the ESRB.

At the same time, domestic (macro-)prudential policies spill over across borders through the activities of internationally active banks and other financial institutions. Current research conducted by the International Banking Research Network (IBRN), for instance, shows that prudential instruments often spill over across borders through bank lending.[2] At the same time, international spillovers vary across prudential instruments and are heterogeneous across banks. Bank-specific factors like balance sheet condition and business model drive the amplitude and direction of spillovers to lending growth rates. Accounting for bank-level heterogeneity is thus crucial for understanding the effects of prudential policies. In the past, international spillovers of prudential policy on loan growth rates have not been large on average, but have the potential to grow with broader use of macro-prudential instruments.

Hence, macro-prudential policies and institutions are inherently complex because they involve authorities taking cross-sectoral perspectives (banking, insurance, other financial intermediaries and financial market infrastructures), micro- and macroeconomic perspectives, and cross-country perspectives. There is, thus, no single institutional set-up for the organization of macro-prudential policies and the assignment of powers.[3] Generally though, central banks play an important role in macro-prudential policies across countries, reflecting their expertise in analyzing macroeconomic, system-wide developments in the financial sector and the real economy. The current institutional set-up of the ESRB reflects these different perspectives, and the ESRB has been effective in coordinating these perspectives across European countries.

The ESRB as a body of independent experts provides a forum to openly discuss macro-prudential issues from different angles. It brings together the perspective of micro- and macro-prudential authorities that, as a group, cover the respective national financial systems, together with ESAs and the ECB the European financial system. Therefore, National Competent Authority (NCA) and National Designated Authority (NDA) – the micro- and macro-prudential authorities, respectively – should be represented in the General Board. However, the composition should be flexible enough to reflect the different institutional set-ups and the division of labor at the national level. In some member states the national mandate for macro-prudential oversight is split between the NDA and the national central bank (NCB) – Germany might serve as an example – which, due to their analytical capacities, are responsible for the surveillance of systemic risks. In other member states the national central bank is the NCA/NDA.

Any change in the composition of the Board should, therefore, do justice to the country-specific set-up. Otherwise, the ESRB would run the risk of losing access to the independent analytical capacities of central banks in several member states. The General Board should continue to include representatives from all ESCB central banks. If there are more than two authorities in one Member State, i.e. if NCB, NDA and NCA are distinct authorities, a mechanism similar to Article 6 (2) lit. a) ESRB Regulation may be chosen. In particular, if NCB and NDA are the same authority, the NCAhas the second seat.

Accountability and Decision-Making

While macro-prudential policy in Europe clearly has a cross-border (and cross-sectoral) dimension, it yet takes place in a context of national sovereignty and subsidiarity. This implies that macro-prudential authorities remain accountable to their national electorates, and this national accountability needs to be reflected in the institutional set up of macro-prudential policies. Both, the factors contributing to systemic risks and the costs of potential financial crises, have a strong national component. Costs of financial crisis are largely borne at the national level. Financial stability risks are affected by various factors which have a strong national component such as regional imbalances and national laws.

The financial sectors of EU member states differ substantially, and national characteristics need to be considered in setting up surveillance mechanisms and regulatory interventions. Therefore, and against the background of the Single Rule book, it is important to give sufficient national discretion and flexibility to national macro-prudential authorities when it comes to the actual use and calibration of instruments.

At the same time, national authorities may be subject to political pressure. They are at risk of acting too little or too late in addressing risks to financial stability. In order to alleviate the inaction bias in macro-prudential policymaking, asymmetric powers are needed. “Top-up powers” thus have an important role in addressing the risk of inaction and potential spill-overs of insufficient (from the Euro area perspective) action taken at the national level.

Ensuring timely policy decisions to be taken that reflect cross-border spillovers does not require “scale-down” powers. Instead, they raise two main concerns on their own right. First, the main goal of macro-prudential policies is to increase resilience and to internalize systemic-risk externalities, not to manage the financial cycle. Scaling down powers may run against these objectives. If capital buffers of banks are reduced, resilience of the financial sector in times of crises is weakened. Second, inaction bias or the risk of taking policy decisions which not adequately respond to systemic risk are not only concerns at the national level. Centralized decisions might also be inadequate, and the potential effects could be larger than those of misjudgement at the national level.

The current federal structure of asymmetric powers strikes an appropriate balance between national and European interests, and it seems well-suited in the EU context. It allows the “center” to act against inaction (or, from the perspective of the EU, insufficient action) at the national level in order to safeguard Euro Area-wide financial stability. And it also allows the member states to self-insure against inaction or insufficient action at the level of the ECB in order to safeguard national financial stability.

Overall, it is thus difficult to make the case for a further centralization of macro-prudential policy within the Euro Area (i.e. the SSM) or within the European Union. This applies to coordination of macro-prudential policy beyond the existing harmonized framework, the common rules for reciprocation, and the work of the ESRB. Instead, before any further centralization of macro-prudential policy-making is being considered, it should be carefully assessed which specific measures and sectors would benefit from a harmonized approach, taking into account the structural and regional diversity of the financial system in Europe to date.

3. Strengthening the Role and the Independence of the ESRB

Given the importance of the ESRB in addressing cross-country and cross-sectoral risks to financial stability, measures can yet be taken to strengthen its role and independence.

Resources: Currently, the ESRB depends on ECB resources without clearly specifying financial and organizational arrangements between the two institutions. This has the potential advantage of affording flexibility, but experience shows that clarifying roles and responsibilities could increase effectiveness and efficiency. Ideally, the ESRB should have resources that are independent of the ECB. In addition to providing clarity with regard to institutional structures, this may enhance independence of the ESRB in voicing potential issues concerning the ECB and the SSM. Unlike today, this issue was of no concern at the time when the ESRB was established as the ECB had not assumed the role of a micro-prudential banking supervisor and had no macro-prudential competencies.

Moreover, the cross-sectoral orientation of the ESRB could be strengthened. At the same time, a closer cooperation with the ESAs is warranted in order to foster the cross-sectoral analytical capacities, risk analysis beyond banking and in order to ensure that relevant financial stability risks identified by the sectoral supervision authorities are covered. In particular, it is proposed that the ESAs support both the secretariat and the analysis section of the ESRB by transferring additional staff to the ESRB.

The visibility of the ESRB and its ability to contribute the macro-prudential perspective in EU policy-making could be enhanced by creating the position of a Managing Director besides the ESRB chair. While the ESRB chair would continue to preside the General Board, the Managing Director could represent the ESRB in the public or in EU committees. This could enhance the credibility, ownership and visibility of the ESRB as a body with a clear macro-prudential mandate. Particularly, it would strengthen its ability to address warnings and recommendations to financial supervisors. Additionally, the establishment of a Research Director (or Chief Economist) might additionally steer the ESRB’s analytical power towards issues of value added.

Data: In conducting system-wide risk analysis, the ESRB largely relies on ECB resources as well. In order to make use of its own comparative advantage and to deliver analyses of value added, the ESRB and its working groups need to have access to relevant data and information. Hence, improvements could be made to data exchange procedures, especially with regard to data that are already available in other authorities (ESAs, SSM or at the national level). Procedures for data access should be streamlined. In this context, it would be useful to review Article 15 (6) and (7) of the ESRB Regulation.[4] In case of data gaps that restrain the ESRBin fulfilling its mandate, the ESRB should, first of all, rely on its powers to issue warnings or recommendations asking the respective ESAs or national authorities to close those data gaps.

Improving resources and data access would also strengthen the ESRB as a hub for the ex-post evaluation of macro-prudential policies. More specifically, the ESRB could coordinate analytical work for the evaluation of specific policies (e.g. by setting up dedicated working groups) and ensure high quality output by coordinating peer-reviews of the evaluation.

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1 The respective ESAs are the European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIPOA) and the European Securities and Markets Authority (ESMA).

2 For details, see "Cross-Border Prudential Policy Spillovers: How Much? How Important? Evidence from the International Banking Research Network" (2016), Claudia M. Buch (Deutsche Bundesbank) and Linda Goldberg (Federal Reserve Bank of New York) (mimeo). The International Banking Research Network (IBRN) was founded in 2012 to inform, both the academic and the policy debate, on current issues related to international banking. It is a multi-country initiative, bringing together research teams from 25 central banks, the International Monetary Fund (IMF), the Bank for International Settlements (BIS), and the European Central Bank (ECB). The current list of participating central banks and institutions as well as country studies are available at www.newyorkfed.org/IBRN/index.html.

3 For a recent review of country-specific experiences, see International Monetary Fund (IMF), Financial Stability Board (FSB), Bank for International Settlements (BIS) (2016). Elements of Effective Macroprudential Policies: Lessons from International Experience. www.fsb.org/wp-content/uploads/Elements-of-Effective-Macroprudential-Policies1.pdf.

4 See also p. 15–17 of the report of the High-Level Group on the ESRB Review, March 2013, available at: www.esrb.europa.eu/pub/pdf/other/130708_highlevelgroupreport.pdf?e913faa529f509c934cd484435ad13a8