Mario Draghi: Macroprudential policy in Europe

Welcome remarks by Mr Mario Draghi, President of the European Central Bank and Chair of the European Systemic Risk Board, at the fourth annual conference of the ESRB, Frankfurt am Main, 26 September 2019.

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It is my pleasure to welcome you to the fourth annual conference of the European Systemic Risk Board (ESRB). Since this is the last time I will open this conference as Chair of the ESRB, I wanted to reflect on the development of macroprudential policy over the course of the past eight years. In that time it has evolved from an idea that mostly existed on paper into policy instruments that have been widely implemented. Europe is now better placed to prevent or mitigate risks to financial stability than it was in the run-up to the global financial crisis.

Yet there is still unfinished business: analytical tools to assess systemic risk need to be enhanced; macroprudential instruments to prevent or mitigate systemic risk need to keep pace with the evolution of the financial system; and the policy framework needs to be further developed.

Establishing macroprudential policy in Europe

At the start of my term in 2011, Europe was still dealing with the aftermath of the global financial crisis. Other financial stability risks – notably those associated with the sovereign debt crisis – were also crystallising. The costs to society from the crisis were substantial.[1] By 2013, unemployment had risen by 10 million and EU GDP was some 13% below its pre-crisis trend.[2]

The build-up of excessive leverage in the financial system was a key element leading up to the financial crisis, and policymakers were unable to adequately address systemic risk. While many central banks communicated on financial stability issues prior to the crisis, very few countries had established national macroprudential authorities with a specific mandate and precise instruments for policy action.

Some of the tools that we would today call macroprudential instruments were used by central banks in Europe during the post-war period, albeit usually for the purpose of demand management.[3] But most were no longer used or were dismantled by financial deregulation during the 1980s and 1990s. And without means of enforcement, warnings published in financial stability reports prior to the crisis often went unheeded.

It was only after the crisis that there was widespread recognition of the importance of the macro dimension of financial stability.[4] An internet search on the word “macroprudential” yields 5,000 hits for the eight-year period from 2000 to 2007. By contrast, the past eight years yield 120,000 hits.

Despite that recognition, macroprudential policy in Europe was far from operational in 2011. Indeed, when the European rules establishing a common legal basis for macroprudential instruments for banking came into effect in January 2014, ten Member States still had not implemented them in primary national legislation.

Even where national authorities had been created, there was uncertainty over the right way to assess risks, which instruments to use and how to calibrate interventions. Moreover, there was a real risk of inaction bias since the costs of macroprudential policy are visible and are felt immediately, but the benefits accrue over time and are difficult to quantify.[5]

Given this somewhat tentative start for macroprudential policy in Europe, substantial progress has been made over the past eight years. Macroprudential authorities now exist in all but one Member State. The gaps in our framework and knowledge have slowly been filled through research and experience. The ESRB has played an integral part in this process.[6]

The framework has also helped to counter the risk of inaction bias. National macroprudential authorities have mandates and legal tools to act. At the European level, the ESRB also holds a mandate to monitor risks and vulnerabilities and has a number of legal instruments at its disposal. It can, for example, issue warnings if it has identified a significant risk to financial stability, as well as recommendations setting out remedial steps to be taken on an act-or-explain basis.

National authorities have certainly demonstrated their willingness to use the tools at their disposal. Most EU countries currently have at least one measure in place to address risks in the residential property sector and half have measures to tackle risks in commercial real estate. 12 Member States have decided to impose a positive rate on the countercyclical buffer.[7]

The ESRB has likewise taken action. In 2016, it issued warnings to eight countries, drawing attention to medium-term vulnerabilities in the residential real estate sectors. In six of these countries, the ESRB judges that the vulnerabilities have not been sufficiently addressed and on Monday published recommendations setting out remedial action to be taken.[8] Five further countries were issued with warnings.[9]

Areas for further progress in macroprudential policy

Yet the overall framework for macroprudential policy in Europe remains incomplete. We need progress in three key areas to counter systemic risk more effectively: better analytical tools, new instruments that counter the development of risk outside the banking sector and a clearer framework to govern policy actions.

The past decade has seen a sustained improvement in the tools available to assess risks to financial stability. Better data and better modelling techniques have revealed important insights.

Developing the analytical toolkit to adequately monitor interconnectedness and contagion requires granular datasets, and the ability to map and link data across entities and markets. The sub-prime crisis in the US banking sector spread to European banks through their direct exposures, but it also spread to insurers through the use of credit default swaps.[10]

Only a holistic view of the system will allow potential contagion channels to be identified and modelled. And that requires investing in new technologies for data analytics and enhancing the capacity for authorities to link and share data and technical knowledge.

The second area of improvement for the macroprudential framework in Europe involves keeping pace with developments in the financial system. That requires broadening the range of macroprudential instruments beyond those currently available, which focus almost exclusively on the banking sector.

For the insurance sector, the contours of such instruments are taking shape. They include solvency instruments such as symmetric capital requirements for cyclical risks; liquidity instruments for insurers with a vulnerable liquidity profile; and instruments to target bank-like activities to ensure macroprudential policy is consistent across sectors.[11]

The third area for improvement in macroprudential policy involves establishing a clearer conceptual framework to govern policy discussions and interventions. Such a framework would facilitate communication with market participants and the general public, as well as help mitigate any risk of inaction bias.

For monetary policy the framework is well known and the reaction function of central banks is normally well understood by markets.

By contrast, the framework that governs macroprudential policy interventions is much less developed, due in no small part to our limited experience of using these tools. The objective of financial stability is broader than the objective of price stability, so is less easily defined by a single numerical measure.

Developing the policy framework is challenging and will take time. The ESRB approach uses the concept of residual risk, which is the difference between the level of risk and the current resilience of the financial system.[12] In setting up the framework, policymakers need to establish the level of residual risk that they consider acceptable.

Regular macroprudential policy decisions would then follow a two-stage process. Policymakers assess the level of residual risk in the system, and if that diverges from the acceptable level, they then assess the policy tightening or loosening required to realign it.

Conclusion

Let me conclude.

Over the past eight years, the implementation of macroprudential policy in Europe has substantially improved, and the ESRB has played a valuable role in facilitating that process.

The ESRB's success derives from its broad membership. Systemic risk takes different forms over time, so discussions incorporating a wide range of viewpoints and experience are vital if policymakers are to successfully safeguard the stability of the financial system.

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1 See, for example, European Commission Staff Working Document, Coping with the international financial crisis at the national level in a European context, p.11, which shows that even in 2015 the contribution of the state to financial sector repair represented more than 10% of total public debt in many countries.

2 ESRB (2014), *ESRB Flagship report on macroprudential policy in the banking sector.*

3 Kelber, A. and Monnet, É. (2014), "Macroprudential policy and quantitative instruments: a European historical perspective, *Financial Stability Review*, Banque de France, April, 18: 151–160.

4 Some discussion had certainly taken place prior to the crisis. See, for example, Crockett, A. (2000), "Marrying the micro- and macroprudential dimensions of financial stability", BIS speeches, 21 September; Borio, C (2003), "Towards a macroprudential framework for financial supervision and regulation?", *CESifo Economic Studies*, 49: 181–216.

5 See ESRB (2014), op. cit.

6 See, for example, Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3); Recommendation of the European Systemic Risk Board of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1); the ESRB response to the European Commission's Consultation Document on the "Review of the EU Macro-prudential Policy Framework"; and the ESRB handbook on operationalising macroprudential policy in the banking sector.

7 See the ESRB's website for a breakdown by country. The ESRB's annual review of macroprudential policy in the EU provides a detailed description of these measures.

8 Belgium, Denmark, Finland, Luxembourg, the Netherlands and Sweden.

9 Czech Republic, Germany, France, Iceland and Norway.

10 Hellwig, M (2009), "Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis", *De Economist*, 157(2): 129–207.

[11] See ESRB (2018), *Macroprudential provisions, measures and instruments for insurance*, November. For recent work on the topic by the European Insurance and Occupational Pensions Authority (EIOPA), see, for example, EIOPA (2019), *Discussion Paper on systemic risk and macroprudential policy in insurance*, March.

[12] ESRB (2019), *Features of a macroprudential stance: initial considerations*, April.