Luis de Guindos: Macroprudential policy after the COVID-19 pandemic

Panel contribution by Mr Luis de Guindos, Vice-President of the European Central Bank, at the Banque de France / Sciences Po Financial Stability Review Conference 2021 “Is macroprudential policy resilient to the pandemic?”, 1 March 2021.

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Introduction

It is a great pleasure to be here this afternoon and share some thoughts on the future of macroprudential policy in the euro area after the coronavirus (COVID-19) pandemic.

About one year ago, the euro area was hit by a major unexpected shock: the COVID-19 pandemic. While this health and economic crisis has had, and continues to have, a severe impact on European citizens and businesses, the euro area banking sector has so far weathered the crisis well. Rather than being part of the problem, it has been part of the solution. The banking sector has managed to support the economy through continued lending, including to the sectors most affected by the lockdown measures. Compared to past crisis episodes, there are two main reasons why banks have played a different role in this crisis.

First, in terms of capital and liquidity, the euro area banking sector was much better prepared than it was before the great financial crisis. This was not least due to the progress made over the past decade in strengthening the regulatory standards for banks and moving towards the banking union.

Second, credit provision during the pandemic has been aided by decisive government support measures, such as public loan guarantees and direct and indirect support to firms, and by relief measures taken by micro- and macroprudential authorities. Specifically, ECB Banking Supervision allowed banks to temporarily operate below the level of capital defined by Pillar 2 guidance and the combined buffer requirement and recommended that banks refrain from dividend payments and share buy-backs. On the macroprudential side, several national authorities either announced a full release of countercyclical capital buffers or revoked previously announced increases to these and other buffers. Together, the micro- and macroprudential measures were a strong signal to banks that they should make use of their existing capital buffers to continue to provide key financial services and absorb losses while avoiding abrupt and excessive deleveraging that would be harmful for the economy.

In my remarks today, I will focus on two key challenges which have become increasingly relevant in recent years and which should be part of our reflections on the future of macroprudential policy after the COVID-19 pandemic. These challenges relate to the creation of what we call “macroprudential space” and to the complementarities between monetary policy and macroprudential policy in a monetary and banking union. As I will argue, addressing these two challenges will increase the effectiveness of the macroprudential framework and strengthen the resilience of the euro area banking sector to major unexpected shocks in the future.

Macroprudential space

The experience of the initial phase of the pandemic illustrated the importance of having sufficient releasable capital buffers in the banking sector. When the pandemic struck in early 2020, macroprudential authorities in the euro area had little room for manoeuvre to release macroprudential capital buffers. Only seven euro area countries (including the three home countries of my fellow panel members) had enacted or announced a countercyclical capital buffer requirement above zero. In the euro area banking sector as a whole, countercyclical capital buffer requirements accounted for only 0.2% of risk-weighted assets at the end of 2019. By contrast, structural buffer requirements, comprising the capital conservation buffer, systemic risk buffers and buffers for systemically important institutions, stood at 3.4%. Unlike the countercyclical capital buffer, structural buffers were in principle not designed to be releasable. But, unlike minimum requirements, buffers are there to absorb unexpected losses and to help sustain lending under stress conditions. In short, the fact that only a tiny fraction of capital buffers has been explicitly releasable limited the macro-financial stabilisation function of macroprudential policy.

Banks' reluctance to dip into their existing buffers seems to be driven by a desire to avoid market stigma and to keep some distance from the threshold for automatic restrictions on distributions. This could be an area of concern at the system-wide level, given that recent empirical evidence of bank behaviour during the pandemic suggests that banks are less active in maintaining credit supply if they operate close to the combined buffer requirement. A contraction of the credit supply could compromise the recovery and increase the risks to financial stability. Recent research by ECB staff further suggests that having higher countercyclical capital buffers at the onset of the pandemic, which could have been released during the current crisis, would have led to significantly improved bank lending and reduced the fall in euro area GDP in 2020 without compromising the solvency level of the banking system. [1]

The imbalance between cyclical and structural buffers has gained more attention in the macroprudential debate since the beginning of the pandemic. There seems to be a growing consensus on the need to reassess the current balance between structural and cyclical buffers and to create more macroprudential space that could be used in a system-wide crisis if needed. I strongly welcome this development and encourage further work and discussions on this important topic, including on specific ways to create macroprudential space.

While it would be premature to envisage a certain outcome at this point, I would like to suggest three guiding principles for further deliberations on this topic. First, the creation of macroprudential space should be capital-neutral. In other words, it should be achieved by amending or rebalancing certain existing buffer requirements rather than by creating additional buffer requirements for banks. Second, the additional macroprudential space created in this way needs to have strong governance in order to ensure that capital buffers are released in a consistent and predictable way across countries when facing severe, system-wide economic stress. Third, considerations to create macroprudential space should focus on options that ensure continued compliance with applicable international standards set by the Basel Committee. The capital conservation buffer would be a natural candidate for creating macroprudential space if it was made releasable in a context where these principles were adhered to. Specifically, the possible release of the capital conservation buffer in a system-wide crisis should be centrally governed in the euro area and could be combined with dividend restrictions in order to maintain equivalence with international standards.

Complementarities between macroprudential and monetary policy

The second challenge relates to complementarities between macroprudential and monetary policy. As widely recognised in the literature, policy outcomes can be improved if complementarities between these two policy areas are exploited.[2] For instance, during phases of risk build-up, effective macroprudential policy can unburden monetary policy with respect to financial stability concerns. An advantage of macroprudential instruments in this respect, and which is particularly relevant in a monetary union, lies in the possibility to target the use of instruments towards certain sectors and to address asynchronous business and financial cycles across Member States. Similarly, during phases of risk materialisation, releasing macroprudential policy buffers can support monetary policy via the impact on banks' credit supply.

Exploiting the complementarities between monetary and macroprudential policy requires a structured approach to the interaction between the two policy areas. In a monetary and banking union, the institutional dimension to the issue requires further reflection in the medium term. Under the current institutional architecture of the monetary and banking union, monetary policy and microprudential policy decisions for significant institutions are taken centrally in the euro area. By contrast, macroprudential policy decisions are primarily taken in a decentralised manner by national authorities, with the ECB only having asymmetric powers for certain instruments, as set out in the SSM Regulation. In particular, the SSM Regulation assigns to the ECB the power to apply more stringent measures or higher requirements for a specific set of instruments defined in the single rulebook.

Based on this institutional setting, a major challenge lies in how to foster a coherent policy mix across macroprudential policies and monetary policy in the euro area, taking into account that assessing the interaction and complementarity is even more important in a monetary union than in a single jurisdiction. A coordinated macroprudential policy response across the euro area is vital to strengthen the impact of policy actions and to support monetary policy, for instance through the release of macroprudential buffers in a system-wide crisis. Greater coordination of macroprudential action across the euro area would also foster timely policy action, reduce fragmentation across national lines and better account for cross-border systemic spillover effects. Furthermore, beyond coordination, the use of selective macroprudential tools at the system-wide level should also be considered, without prejudice to the ability of the national macroprudential authorities to act at the national level to address idiosyncratic shocks.

Looking ahead, I believe we need to reflect on the merits of improving the current governance framework for macroprudential policy in the euro area by complementing it with a centrally managed countercyclical macroprudential tool. More specifically, the reflections should in my view consider an increased role for the ECB's Governing Council in macroprudential policy, given its special role in and responsibility for both monetary and macroprudential policy in the euro area, as set out in the Treaties and in the SSM Regulation.

Conclusions

Macroprudential policy has helped to mitigate the short-term impact of the pandemic on the euro area economy, alongside monetary, fiscal and other prudential policies. The COVID-19 crisis also illustrated the benefits of releasable bank capital buffers, supporting the case for rebalancing between releasable and structural capital buffer requirements to create macroprudential space in the near term. The post-pandemic period will also provide an opportunity to reflect on ways to make macroprudential policy more effective. In addition to possible changes to macroprudential instruments, these considerations should touch upon the governance of macroprudential policy in the European monetary and banking union in order to make best possible use of the complementarities between monetary and macroprudential policy.

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[1] See Darracq, M, C. Kok and M. Rottner (2020), "Enhancing macroprudential space when interest rates are low for long", *Macroprudential Bulletin*, ECB. The authors find that a countercyclical capital buffer 125 basis points higher could have reduced the decline in real GDP by around 1 percentage point in 2020.

[2] See e.g. Darracq, M, C. Kok, E. Rancoita (2019), "Macroprudential policy in a monetary union with cross-border banking", *Working Paper Series*, No 2260, ECB.