



## **ESRB response to the European Commission’s Consultation Document on the “Review of the EU Macro-prudential Policy Framework”**

### **Executive summary**

With this response to the European Commission’s Consultation Document on the “Review of the EU Macro-prudential Policy Framework”, the ESRB’s General Board intends to outline its priorities. In particular, the General Board believes that:

- The ESRB should remain closely linked with the ECB/ESCB – including the de jure chairmanship of the ESRB held by the ECB’s President – while institutional proposals to strengthen its governance, such as a two-tier managerial structure, might be considered;
- The General Board should continue to have a broad composition, in line with the ESRB’s function to act as a forum for cooperation among institutions that contribute to preserving financial stability across the European Union;
- The ESRB should continue to play a central role in the dialogue among macroprudential authorities and in the assessment of their macroprudential measures, including the assessment of cross-border and cross-sector spillover effects;
- Several microprudential instruments applicable to banks are also usable as macroprudential tools, and vice versa. A technical annex to this document discusses the different experiences of ESRB members and possible approaches to providing a clarification of objectives and procedures;
- The reciprocation of national exposure-based measures should become the rule, albeit with exceptions in justified cases;
- Comprehensiveness, flexibility and simplicity in the design of the macroprudential toolkit for banking are of the essence. In each country, there should be an adequate set of tools available to respond to a wide range of systemic risks. Substantial flexibility should be allowed in their use;
- Simplification of the activation procedures for the tools, compared with the current situation, is warranted. The hierarchy of instruments for the mandatory sequencing of their activation should be removed and replaced by one single activation procedure, with no inherent “pecking order”, so as to remove adverse incentives in the selection of macroprudential instruments. A few technical annexes discuss these issues;
- While recognising that macroprudential instruments outside banking already exist for selective purposes, there is a general need to establish a comprehensive macroprudential toolkit beyond banking. In particular, instruments such as margin and haircut requirements for derivatives and securities financing transactions, as well as liquidity and leverage requirements for investment funds, should be further investigated and, where appropriate, the regulatory framework could be expanded. Moreover, the design of recovery and resolution

regimes for central counterparties and insurance corporations should have a macroprudential profile;

- The European System of Financial Supervision, of which the ESRB is part, should play an important role in the identification and design of the macroprudential policy tools beyond banking.

An important part of the consultation by the European Commission touches upon possible changes to powers and duties of macroprudential authorities and the ECB, within the Single Supervisory Mechanism (SSM), in accordance with the SSM Regulation. These issues are not discussed in this response, as the input set out here is meant to focus on ESRB priorities.

Finally, some of the proposals outlined below may require international coordination. This is particularly true in the case of macroprudential tools to be applied to financial markets and market infrastructure, due to the global nature of the relevant markets. This input does not discuss these international aspects.



## 1. Introduction

**The ESRB welcomes the opportunity to respond to the European Commission's Consultation on the Review of the EU Macroprudential Policy Framework.** The ESRB believes that its central role in the macroprudential framework in the European Union places it in a good position to contribute to the review of the framework. Reflecting this role, the ESRB believes that its comparative advantage is to provide a bird's eye perspective on key issues, while discussing some more specific issues in detail (see annexes).

**ESRB members have taken note that the surrounding institutional framework has been modified** by the introduction of the banking union and, in particular, by the attribution of certain macroprudential powers to the SSM. Issues concerning the development of powers and duties among euro area members are deliberately left outside the scope of this input.

The remainder of this response is structured as follows: Section 2 considers key issues related to governance; Section 3 considers important issues related to macroprudential tools for banking; and Section 4 considers the need to broaden the macroprudential toolkit beyond banking. Annex 1 discusses the coordination between micro and macro policies; Annex 2 analyses questions concerning the so-called "pecking order" in the activation of instruments; Annex 3 focuses on the demarcation and alignment between the O-SII Buffer and the Systemic Risk Buffer (SRB); and finally Annex 4 dwells on the possible introduction of a sectoral use of the countercyclical capital buffer.

## 2. ESRB Governance

### 2.1 Chair of the ESRB

**The ESRB takes the view that a de jure link between the ECB's President and the ESRB's Chair should be created.** While the ESRB remains autonomous and its distinguished organisational identity has been established, it has also strongly benefited from the visibility, independence and reputation of the ECB's President. A possible confirmation of the permanent link between the ECB's President and the ESRB's Chair would strengthen the case of certain complementary proposals, such as the introduction of a two-tier managerial structure.

**The ESRB supports the view that its Secretariat should continue to be hosted by the ECB.** The analytical efforts, access to relevant data and logistical/budgetary support provided by the ECB have been crucial to establish the credibility of the ESRB and have greatly facilitated its functioning. Moreover, there is a need to strengthen the analytical resources of the Secretariat to promote independence.

### 2.2 General Board

**The composition of the ESRB's membership is a distinctive feature of the ESRB, which considers it an important source of strength.** The fact that the ESRB's General Board (and its Advisory Technical Committee, which mirrors the General Board's composition) brings together more than 70 authorities means that it can draw on the broad expertise of its members (central banks, national competent authorities, the European Supervisory Authorities (ESAs), the European Commission, the Economic and Financial Committee and the ESRB's own Advisory Scientific Committee). As a result, extensive analytical and staff support is provided to the ESRB by participating institutions, ensuring that both the assessment of systemic risks and development of policy proposals are based on a uniquely wide range of views and a broad set of information across all parts of the EU financial system. Moreover, this set-up is crucial for the ESRB to fulfil its mandate since it has no binding powers but relies on moral suasion and peer pressure. Furthermore, as



highlighted in Section 4 of this report, macroprudential policy will require a richer set of instruments to better prevent and mitigate financial stability risks stemming from the broader financial system. In other words, expanding the macroprudential framework beyond banking should be seen as a priority. The broad range of expertise at the level of the ESRB's General Board should be seen as being vital in fulfilling this task.

**The ESRB believes that the composition of its General Board should reflect the new institutional set-up both at the European and the national levels.** It is important that the ESRB's membership includes those authorities that have the main macroprudential responsibility at the national level and which are currently not represented, but without giving them voting rights. However, the leading role of the central banks should be preserved. Moreover, the ESRB believes that the representative of the Single Resolution Board and the representative of the SSM should be members of its General Board (and, accordingly, these authorities should be represented on the Advisory Technical Committee). In fact, a practice to invite the representatives of the Single Resolution Board and the SSM to meetings of the General Board and of the Advisory Technical Committee as observers has already been established. Furthermore, it would be beneficial if the SSM was represented on the Steering Committee. To this end, a practice has also already been established.

**Given its characteristics, the ESRB believes that its institutional framework functions well.** The ESRB's General Board has made regular use of votes during its meetings and has made use of the possibility for decision-making via written procedures. Emphasis has been placed increasingly on well-structured meetings. As regards the latter, the important role of advisory committees and, in particular, the Advisory Technical Committee, which prepares the General Board's discussions, should be underlined.

**The ESRB sees merit in delegating some of the General Board's responsibilities within its organisational structure.** In particular, consideration might be given to empowering the Advisory Technical Committee to take decisions on a number of operational issues (such as requests concerning the exchange of aggregated and firm-specific data, which might be further simplified). This would require amending the ESRB Regulation to give the General Board the possibility to delegate some responsibilities to the Advisory Technical Committee, with the General Board retaining the authority to reconsider delegations of responsibilities. However, the delegation of powers to the Steering Committee would not be warranted, as it is not representative of the ESRB's membership.

### 2.3 Advisory Committees

**The ESRB believes that its two advisory committees are decisive for it to be able to fulfil its mandate, with their diversity further adding to the ESRB's strength.** First, the smooth decision-making process in the General Board is ensured by preparations at the level of the advisory committees. In particular, the Advisory Technical Committee, whose membership mirrors that of the General Board, prepares the General Board's discussions and policy-making decisions. Second, the macroprudential decisions of the General Board are supported by the research conducted by the Advisory Scientific Committee, which also contributes to the public debate on macroprudential policy by publishing its reports. The two committees work closely together in joint expert groups (for example on shadow banking and interconnectedness).

### 2.4 Access to data

**The ESRB considers it warranted to review its regulation in order to streamline the processes for accessing data, in particular regarding the provision of entity level data.** Timely access to relevant data is key for the ESRB to fulfil its mandate to identify and prioritise systemic risks, and to issue warnings and recommendations when risks are deemed significant. Newly established macroprudential authorities should be part of the same data-sharing regime.



### 3. Macroprudential instruments for banking

#### 3.1 General considerations

**Up to now, macroprudential policy in the European Union has been almost exclusively restricted to the banking sector.** This reflects the importance of the banking system in the EU financial system, as well as the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) in providing a sound legal framework for the use of macroprudential instruments to address risks in the banking sector. EU Member States have also made extensive use of instruments under national law, inter alia to address systemic risks originating from the real estate sector. From the start of the implementation of CRD IV/CRR, the ESRB has supported the development and implementation of macroprudential policymaking in the banking sector through a range of initiatives.

**As an overarching principle, the ESRB would like to stress the importance of national flexibility in macroprudential policymaking and the use of instruments to address risks at the national, regional or sectoral levels.** It is crucial that macroprudential authorities are not unduly constrained in their ability to take the necessary actions to address, proactively, the build-up of systemic risks in their jurisdictions because of the risk of inaction bias in this area. At the same time, the ESRB recognises that this flexibility needs i) to be balanced with certain rules and procedures to safeguard the integrity of the single market, and ii) to take into account the EU-wide nature of some risks in an integrated market. Later in this response, a number of cases are identified where this national flexibility could be further enhanced.

**The ESRB is of the view that, overall, the CRD IV/CRR framework provides the essential elements for a sound EU macroprudential framework for the banking sector.** However, in the course of its work, the ESRB has also identified the need for some specific changes to further improve the effectiveness of the framework, which are discussed in greater detail below. In particular, the macroprudential framework would benefit from more procedural clarity and simplification in certain areas. For example, the ESRB could become the central hub for all notifications regarding macroprudential measures in the European Union, thus reducing the overall notification burden. Furthermore, the ESRB sees merit in having a regular review of the macroprudential framework, for example every three to four years, as further experience with the framework is gained.

**The ESRB agrees with the European Commission's observation that the effectiveness of the macroprudential toolkit could be further enhanced.** In particular, overlaps between individual instruments, uncertainty concerning their hierarchy for the mandatory sequencing of their activation, and differing activation mechanisms have the potential for impeding the effective use of macroprudential instruments. For example, the ESRB has stressed on a number of occasions that clarifying the focus and scope of activity-based macroprudential instruments and addressing overlaps between measures pursuant to Article 458 of the CRR, on the one hand, and Articles 124 and 164 of the CRR, on the other hand, would facilitate the application of the existing framework.

**The ESRB considers that a clarification of policy goals and procedures would facilitate the day-to-day management of macroprudential policies.** As a general principle, a clear distinction should be made in the responsibilities and powers by assigning specific tools to either the micro- or the macroprudential authorities to the extent possible, thus ensuring both have a sufficient and effective toolkit to deliver on their objectives. Nevertheless, the ESRB takes note that the current text of CRD IV makes it possible to use Pillar 2 measures for macroprudential purposes. To date the ESRB has observed different practices in the use of these tools. Exchanges of views among the ESRB's members have shown that the different practises are also reflected in different perspectives as to the review of the macroprudential policy framework (see Annex 1).



While acknowledging that a clear allocation along the above lines would be beneficial but may be difficult to achieve at the current juncture, **the ESRB strongly advises to:**

- Provide for a better coordination between competent and designated authorities for the macroprudential use of Pillar 2 and for the application of Articles 124 and 164 of the CRR, and to ensure the use of the most appropriate instrument and avoid the double-counting of risks. However, the offsetting of micro- and macroprudential actions must also be avoided (see Annex 1);
- Remove the mandatory sequencing for the activation of instruments and replace it with a single activation procedure with no inherent “pecking order”, in order to avoid any adverse incentives in the selection of macroprudential instruments (see Annex 2);
- Align Article 164 of the CRR with the provisions in its Article 124, and clarify the financial stability considerations that, in themselves, should be sufficient conditions under which Articles 124 and 164 of the CRR would apply;
- Increase the flexibility provided to designated authorities in Article 458 of the CRR, aligning it with the flexibility provided to competent authorities in Articles 124 and 164 of the CRR, and extend the competence for Articles 124 and 164 of the CRR to the designated authorities; and
- Extend the time available for providing an ESRB and EBA opinion under Article 133 of the CRD and Article 458 of the CRR to 30 working days, while providing for a mandatory use of notification templates.

Further details on these proposals are provided below and in the annexes.

### 3.2 Instruments to address structural risks

**The main instruments in the CRD IV/CRR for addressing systemic risks of a structural nature are the systemic risk buffer (SRB) and the buffers for systemically important institutions (SII).** Both types of instruments are used by national authorities. While the buffers for global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs) are dedicated instruments which specifically address the risks of SIIs, the systemic risk buffer (SRB), by contrast, can be used to address a broad set of systemic risks of a long-term, non-cyclical nature, such as those related to common or correlated exposures and the structure of the banking system. For example, the SRB can be used to mitigate systemic risk stemming from the “too-many-to fail” phenomenon. Experience has shown that Member States have different needs and uses when applying structural buffers. Therefore, the ESRB argues for adequate flexibility in the use of these tools.

**The main attractiveness of the SRB is its great flexibility in terms of use.** At the same time, this flexibility creates the risk of negatively affecting the use of other instruments designed by the legislator for a specific risk. This is especially the case of the O-SII buffer, which is presently capped at 2%. One can indeed observe that, in several Member States, national authorities have used the SRB to go beyond this legal cap. It would be more appropriate if the dedicated tool were used to address the specific risk it was created for.

**The ESRB is therefore of the view that there would be merit in further clarifying and improving the rules regarding the use of the SRB.** *First*, in the definition of the SRB, it should be clarified that this instrument should not be used to address risks emanating from SIFI-properties of O-SIIs. At the same time, the present cap on the O-SII buffer should at least be substantially increased so that the risks to the financial stability of Member States resulting from the systemic importance of individual institutions can be adequately addressed. This should also be reflected in the cap for subsidiaries of a



G-SII or an O-SII, which is an EU parent institution and subject to an O-SII buffer on a consolidated basis. *Second*, the SRB should apply either to all credit institutions or to categories of credit institutions with common or correlated exposures (e.g. banks, saving banks, cooperative banks and credit unions) but not to individual institutions. *Third*, in order to better target the specific source of structural systemic risk, it should be clarified that the SRB can also be applied to a subset of (domestic) exposures, in particular sectoral exposures. However, sectoral SRBs should also be calibrated and applied on the basis of total risk-weighted assets in order to maintain the consistency and transparency of the SRB framework. *Fourth*, as there may be different sources of systemic risk of a structural nature that justify the use of an SRB, authorities should be allowed to impose more than one SRB level when distinct risks are being addressed. In case the SRB also targets exposures in other Member States, an enhanced coordination procedure between authorities should be put in place. *Fifth*, in addressing sources of systemic risk other than the SII buffers, the SRB should be applied in addition to the maximum of the G-SII and O-SII buffers; furthermore, the procedures for coordinating the SRB and O-SII buffers should be simplified, for example by putting in place a notification and approval procedure when the combined buffers exceed a specific threshold. *Sixth*, the SRB should be made available as a macroprudential instrument in the jurisdiction of all Member States, which would further facilitate reciprocity.

**The ESRB recognises that some improvements can also be made as regards the O-SII buffer regime.** As mentioned above, the present cap of 2% on the O-SII buffer should at least be substantially increased in order to allow authorities to adequately address the risk resulting from O-SIIs. This change would also need to apply to the case of O-SIIs that are subsidiaries of parent O-SIIs located in another Member State. Moreover, authorities should be able to require institutions within their jurisdictions to hold O-SII or SRB buffers on multiple levels of consolidation in order to avoid incentivising the double-counting of capital. As with the mechanism foreseen for the G-SII buffer, the designated authority should be obliged to set an O-SII buffer rate if an institution has been identified as an O-SII. Nevertheless, this buffer could be set at 0% if circumstances warrant it – for example, depending on the business model of the firm in question – and in the light of other prevailing policies to mitigate the risks. Generally, the O-SII buffer regime in the European Union should be more closely aligned with the framework for domestic systemically important banks devised by the Basel Committee on Banking Supervision (BCBS). Furthermore, first experiences with the O-SII buffer framework point to quite some variation in the design and calibration of the O-SII buffers across the European Union. A higher degree of consistency could be achieved through EBA guidelines on the design and calibration of O-SII buffers that would provide guidance and set minimum standards for the relevant authorities.

Further considerations on the demarcation between SRB and O-SII buffers are included in Annex 3.

### 3.3 Instruments to address cyclical risks

**The ESRB recalls that the main instrument in the CRD IV/CRR for addressing systemic risks of a general cyclical nature is the countercyclical capital buffer (CCyB) and that it has done extensive work in this area.** First, the ESRB issued a Recommendation on guidance for setting countercyclical capital buffer rates. Second, it issued a Recommendation on recognising and setting countercyclical buffer rates for exposures to third countries. Third, the ESRB has put in place an infrastructure on its website for publicly disclosing the CCyB rates decided by all the national authorities in the European Union, together with supporting information underlying these decisions.

**The ESRB has already taken the view that some more work may be required to make cyclical instruments fully operational.** The ESRB has observed that the active use of capital buffers, including the CCyB, as macroprudential policy instruments would be negatively affected if CET1



capital used to comply with the buffers could also be used to fulfil other requirements, such as MREL (minimum requirement for own funds and eligible liabilities), as this would reduce its flexibility. Such a practice should not be allowed, and buffer capital should not be allowed to be used to cover MREL or TLAC (total loss absorbing capacity) requirements.

**The ESRB takes the view that a more targeted application of the CCyB could be considered, where a CCyB is applied not only on a broad basis but also to specific segments of the credit market (e.g. exposures to real estate and to the intra-financial sector).** Such a regime, for example, is already in place in Switzerland and is under discussion by the BCBS. It would allow a more targeted approach to addressing cyclical risks originating from a specific sector (e.g. the residential real estate sector and intra-financial exposures). However, before moving in this direction, one should take into account possible overlaps and interactions with the general CCyB (for example concerning activation and calibration) and other instruments<sup>1</sup>, as well as the implications of a divergence from, or a need to coordinate with, the BCBS. Moreover, as the structural and cyclical dimensions of macroprudential policy are not implemented in isolation, further reflection on the interaction between these two dimensions is required. More specifically, the activation or increase of a structural buffer may have an impact on the cyclical dimension as well, which poses particular challenges also as regards communication (see Annex 4).

**The release phase of the CCyB should be addressed in greater detail in EU legislation, which presently focuses on the build-up phase in terms of buffer activation.** In the build-up phase, it is important to increase the resilience of the banking sector and to curb – to a certain extent – the financial and economic cycle in a timely manner. However, in the release phase, it is important to use this buffer first and foremost to absorb actual and expected losses stemming from the downturn phase without permitting banks, for instance, to use the capital relief to increase dividend distributions. Nevertheless, in the light of our developing understanding on the practice and use of the CCyB, the ESRB does not advocate enshrining in law an exhaustive or restrictive set of factors determining the release phase.

**The ESRB has consistently taken the view that there is a need to allow for sufficient flexibility in the use of Articles 124 and 164 of the CRR to address systemic risks originating from real estate lending.** Also in this context, a clear allocation of responsibilities and tools would be beneficial, where competent authorities would use Articles 124 and 164 of the CRR to deal with risks to firms' safety and soundness, and the macroprudential authorities would have similar instruments in their toolkit to address real estate risks from a systemic or financial stability perspective. However, taking into account the current legal text, these articles allow competent authorities to increase risk weights (RWs) and loss-given-default parameter thresholds (LGDs), or apply stricter criteria than usual, on the basis of financial stability considerations. The ESRB is of the view that financial stability considerations in themselves should be sufficient to allow such increases in RWs and LGDs, drawing on a broad set of indicators and expert judgement, rather than using a narrow approach based on credit losses. Given that similar considerations form the basis for using Articles 124 and 164 of the CRR, the ESRB is also of the opinion that the conditions for the use of both articles by the national competent authorities should also be similar; the wording of the two articles could be better aligned in that respect. Moreover, as reference is made to financial stability considerations and the identification and mitigation of financial stability risks is within the remit of macroprudential authorities, designated authorities should have the possibility to increase the RWs and LGDs for macroprudential policy purposes.

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<sup>1</sup> Including an SRB on the basis of real estate exposures, as mentioned above.



**Another way forward to address cyclical risks, in the ESRB's view, could be the macroprudential use of liquidity instruments.** In the past, the ESRB has pointed out that the liquidity coverage ratio and the net stable funding ratio could provide a good basis for a macroprudential framework to address systemic liquidity risk. In particular, a structural funding requirement such as the net stable funding ratio could address excessive maturity mismatches in the financial system, as it focuses on the core intermediation process. The macroprudential dimension of such liquidity instruments could be implemented as an additional time-varying macroprudential buffer requirement over and above the static minimum prudential requirements, similar to the CCyB vis-à-vis minimum capital requirements. An additional liquidity requirement could also be based on structural considerations, such as its application to a sub-set of banks demonstrating common risks resulting from specific funding sources or business models. The ESRB sees merit in introducing such macroprudential tools. If EU legislation were amended in this area, it would be crucial that it did not prevent a macroprudential use of such measures at the national level.

**The ESRB has already taken a firm view that a macroprudential leverage ratio would be another useful part of the macroprudential toolkit.** Currently, such ratios can be used at the discretion of the Member States and several have already implemented such a ratio. Even after the implementation of a common minimum leverage ratio in EU law, a macroprudential use of the leverage ratio should be possible or enshrined in EU law as well. Leverage ratios can be designed to take into account the systemic importance of institutions and differences in structural risks, as well as time-varying risks. The ESRB has already issued guidance on such ratios, thus contributing to enhanced coordination and supporting a level playing field, while still allowing for national specificities.

**The ESRB observes that Member States have made intensive use of macroprudential instruments under national law to address systemic risks originating from (residential) real estate exposures.** Such borrower-based instruments include, for example, the loan-to-value (LTV) ratio, loan-to-income (LTI) ratio, debt-to-income (DTI) ratio and debt service-to-income (DSTI) ratio. As these instruments have often proven to be efficient in addressing systemic risks, they should be available to macroprudential policymakers in all EU Member States. However, the ESRB is also of the view that such instruments – including decisions concerning their design, implementation and application – should be in the hands of national macroprudential authorities.

Nevertheless, the ESRB is also of the opinion that the lack of commonly agreed working definitions on the real estate sector, along with operational constraints on data availability for a number of relevant indicators for financial stability surveillance and policymaking, negatively affects the significance and reliability of the corresponding analyses. The ESRB work on closing real estate data gaps is ongoing and aims to address these concerns. It should therefore contribute to improved macroprudential policymaking also at the national level.

### **3.4 Reciprocity of EU macro prudential instruments and the cross-border dimension of macroprudential policy**

**The ESRB considers reciprocity to be an important policy tool.** Reciprocity seeks to ensure that a macroprudential measure taken in one Member State and targeting a specific risk in that Member State is applied to all financial service providers in the European Union that are exposed to the targeted risk, irrespective of the location of the provider. Reciprocity thereby enhances the effectiveness and consistency of EU macroprudential policy and contributes to a level playing field in the Single Market.

**The ESRB has complemented the mandatory reciprocity provisions in EU law with a voluntary and coordinated reciprocity framework.** Mandatory recognition is currently provided for with regard



to measures taken pursuant to Articles 124(5) and 164(7) of the CRR, and for the CCyB if it is set below the ceiling for mandatory recognition. In 2014, the ESRB advocated the full reciprocation of CCyB rates between Member States. In 2015, the ESRB further advocated a coordinated policy response in the form of an arrangement for voluntary reciprocity for macroprudential policy measures. The voluntary nature of these ESRB arrangements, resulting from the nature of ESRB recommendations, differentiates such voluntary reciprocity from the mandatory recognition of certain macroprudential policy measures under EU law.

**The ESRB supports making reciprocity of exposure-based macroprudential measures under the CRD IV/CRR mandatory as a general rule.** Article 134 of the CRD and Article 458(5) of the CRR should therefore foresee mandatory reciprocation in case of measures that cover domestic exposures in the activating Member State. For that purpose, measures of the activating Member State should be made publicly available in all official EU languages, for example through publication in the Official Journal of the European Union. In addition, the scope of Article 458 of the CRR should cover EU banks' exposures to the activating Member State both through branches in that Member State and direct cross-border exposures to that Member State. In certain cases, however, mandatory reciprocity may be unduly burdensome and outweigh any potential benefits, leading to both jurisdiction-level and institution-level exceptions in de minimis cases, which would have to be identified ex ante through jointly defined and harmonised thresholds that take into account the perspectives of both an exposed institution and the country which applies the measure. In addition, Member States should also be allowed to opt out of such mandatory reciprocity by means of a notification process, replacing the current requirement to notify if choosing to reciprocate, whereby they explain to the ESRB the rationale for not reciprocating. Finally, reciprocity would benefit from more harmonisation in the macroprudential toolkit.

#### 4. A macroprudential policy framework beyond banking

**The ESRB notes that its Regulation already confers authority to the ESRB to express views and issue warnings and recommendations to the entire financial sector.** Moreover, in a few cases the ESRB could already express recommendations to authorities to make use of existing tools, such as the provisions<sup>2</sup> allowing competent authorities – in close cooperation with the European Securities and Markets Authority – to operationalise limits on leverage for alternative investment funds. Additional tools are available at the national level as recently evidenced also by the International Organization of Securities Commissions. However, there is an insufficient set of instruments to address systemic risks beyond the banking sector, which leaves a gap in the macroprudential policy framework in the European Union. This hampers the prevention and mitigation of systemic risks that originate from, or are transmitted through, a growing part of the financial sector, as competent authorities might not have the tools to operationalise any recommendations issued by the ESRB.

**The ESRB has already identified systemic risks in the financial sector beyond banking.** They concern, for instance, the broad-based implications of a prolonged phase of low interest rates in particular for insurance and pension funds, liquidity and maturity mismatches in the investment fund sector, liquidity conditions in financial markets, possible pro-cyclical effects of financial market practices such as the setting of margins and haircuts, and the systemic importance of central counterparties. The recently published 2015 Annual Report provides a review of these risks<sup>3</sup>. While

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<sup>2</sup> See Article 25(3) of the AIFMD.

<sup>3</sup> See <https://www.esrb.europa.eu/pub/pdf/ar/2015/esrbar2015.en.pdf>



existing EU legislation includes provisions that could be used to mitigate some of these risks, there is no framework at the national and European levels that provides macroprudential authorities with a set of coherent macroprudential policy tools to address systemic risks beyond banking.

**The ESRB believes that some risks currently more prevalent in banking may migrate to the non-bank sector.** The non-bank financial sector has already reached the same size as the banking sector in the European Union in terms of financial assets – a trend that is expected to continue for a number of reasons. In particular, the EU Action Plan towards a capital markets union is expected to further strengthen market-based finance in Europe and lead to a diversified financial system. While a greater share of financial intermediation occurring outside the banking sector can be helpful in smoothing the flow of credit to the real economy and contribute to sustainable growth, it may also give rise to new systemic risks. Moreover, the lack of a comprehensive macroprudential policy framework covering both banks and non-banks may cause activities and existing risks to migrate across sectors for pure regulatory arbitrage reasons.

**The ESRB sees the desire for non-banks to play a greater role in providing sustainable financing to the real economy as another reason to fill this gap in the EU macroprudential policy framework.** Financial stability is a precondition for market development. For example, securitisation markets are still impaired following the effective closure of primary and secondary markets during the global financial crisis. Reviving these markets so that robust securitisations can fulfil their economic function is taking considerable efforts.

**Setting up a legal framework for macroprudential policy beyond banking is, in the ESRB's view, a much needed step to ensure that vulnerabilities can be prevented or muted across the financial sector.** Such a framework requires clear responsibilities and powers to be assigned – a process that would need to start as soon as possible. This is expected to help clarify how macroprudential policy could be operated beyond banking.

**The ESRB notes that macroprudential policy already belongs to EU law.** By establishing the ESRB and assigning financial stability tasks to the ESAs, the EU legislation already recognises that macroprudential policy belongs to the European Union and assigns a role to the European System of Financial Supervision (ESFS) in the area of macroprudential policy. The ESFS, which also includes the national authorities, might therefore be given the joint task to propose to the European Commission ways of enshrining macroprudential policies beyond banking in EU legislation.

**The ESRB also notes that regulation would be more effective if the core regulatory framework was based on internationally agreed standards.** Often, market-based finance operates in a global context, with close ties between financial centres. Moreover, non-bank entities such as asset managers and broker-dealers can have significant cross-border activities stemming from global activities (e.g. involvement in global OTC derivatives markets) and clients with a significant global footprint (e.g. global investment banks)<sup>4</sup>.

**The ESRB believes that the legal basis for using macroprudential tools beyond banking should be created to ensure that authorities have these tools available in the foreseeable future.** Examples of such tools include macroprudential margins and haircuts for securities financing transactions and derivatives, and the imposition of leverage limits on alternative investment funds, where work on technical aspects is well advanced at the ESRB level. The development of instruments to address liquidity mismatches in asset management is also high on the policy agenda of the ESRB and FSB. Implementing macro-prudential policy beyond banking could entail short-run costs, in the form of regulatory effort and constraints on the private sector's actions and potentially on short-term

<sup>4</sup> See: [https://www.esrb.europa.eu/pub/pdf/reports/20160718\\_strategy\\_paper\\_beyond\\_banking.en.pdf](https://www.esrb.europa.eu/pub/pdf/reports/20160718_strategy_paper_beyond_banking.en.pdf).

access to credit. Yet these costs are likely to be smaller than the costs of a systemic crisis, which disrupts financial system functioning, undermines confidence and may require the provision of public support to institutions or markets. Creating the legal basis now would ensure that authorities could, in a timely manner, be in a position to apply such tools if necessary to address systemic risks arising in all financial sectors.



## Annex 1. Micro- and macroprudential tools

### Challenges in dealing with potential overlaps between micro and macro policy measures

**The possibility of making macroprudential use of microprudential tools has allowed the use of these tools in different ways across the European Union.** In a few countries authorities have also used Pillar 2 capital and non-capital instruments, in addition to other prudential tools, to implement macroprudential policies, while ensuring full transparency in respect of their deliberations, when they belonged to the macroprudential realm. In contrast, most countries' authorities have been arguing strongly in favour of a clear separation of macro- and microprudential tools so as to safeguard against the double-counting of risks.

**Turning to forward-looking considerations, there is a general consensus that it would be useful to assign the use of micro- and macroprudential tools more clearly separate goals and procedures.** Some ESRB members consider that it would still be useful to have the additional flexibility provided by the Directive in force, thereby maintaining the provisions of Article 103 of the CRD. Others would prefer Pillar 2 not to be used for macroprudential purposes at all, based on the view that risks of a systemic nature should be addressed solely by macroprudential tools. In this context, Article 458 of the CRR should be enhanced to provide a more flexible macroprudential instrument.

**The arguments of those supporting the maintenance of Article 103 are that it enhances the flexibility and the fine-tuning of decisions.** Moreover, very often macro- and microprudential risks are different aspects of the same underlying issue and may have to be tackled both from the bottom as well as from the top. The same instrument (such as risk weight) can be used to manage both institution-specific and systemic risks. **The arguments of those supporting the deletion of Article 103 include several institutional and substantive aspects.** First, there should be separation between the macro- and the microsupervisory functions to ensure that systemic risks are adequately addressed. Second, Pillar 2 decisions may imply execution by several authorities (requiring coordination), are often not disclosed to the public and might affect the transmission of policy signals.

**If microprudential instruments continue to be used for macroprudential purposes, there would be a need to further enhance and formalise the coordination and cooperation between competent and designated authorities.** More specifically, the use of Pillar 2 measures for macroprudential purposes requires a higher degree of coordination and may result in a lack of transparency. Competent and macroprudential authorities should cooperate and communicate effectively in order to ensure that all relevant risks are addressed and that there is no duplication of prudential requirements for the same risk. The ESRB notes that most Pillar 2 measures addressing systemic risks are applied to cross-border banking groups for which a college of supervisors has been established. Using Pillar 2 in general, and applying capital add-ons in particular, therefore, requires a joint decision by all competent authorities, involving a high degree of supervisory coordination and cooperation. However, at least for the time being, it is not ensured that designated authorities are involved in the process. This lack of involvement of designated authorities has the potential to hamper the effectiveness of the macroprudential application of microprudential instruments. In particular, any offsetting of micro- and macroprudential tools (e.g. via the SREP) should be avoided. Furthermore, the additivity and hierarchy of the capital buffers in relation to the Pillar 2 capital buffers should be clearly defined.

**An optimal and effective macroprudential framework should allow for the flexible use of all available tools to prevent and manage systemic risk.** In their practical application, microprudential



and macroprudential measures are closely linked to each other and cannot easily be separated. Depending on the situation, the same measure may be motivated both by microprudential considerations and by macroprudential ones.<sup>5</sup> Furthermore, regardless of the nature of the purpose behind them, most measures have effects on both the micro and the macro level. Legal certainty should be ensured by clearly defined objectives and scopes for each of the prudential tools.

The ESRB recommends providing for mandatory coordination between competent and designated authorities when Pillar 2 is used for macroprudential purposes. Macroprudential authorities should clearly communicate macroprudential policies to microprudential authorities. Microprudential authorities should clearly communicate their decisions in so far as they are of relevance to the conduct of macroprudential policy (particularly the Pillar 2 stance). As coordination by itself may not be sufficient to address any possible conflicts between competent and designated authorities, a clear hierarchy between policy objectives could also be needed, with predominance given to the macroprudential objective.

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<sup>5</sup> By way of illustration, a single measure such as mortgage risk weights can be used simultaneously as a microprudential measure – addressing the idiosyncratic credit risks faced by banks – and as a macroprudential measure – addressing the systemic risks associated with mortgages.



## Annex 2. Removal of the pecking order

**Economic and financial conditions may differ quite substantially between EU Member States, calling for flexibility in the use of macroprudential tools.** Different financial systems may give rise to different sets of risks and the structure of the system may exacerbate or mitigate those risks. Therefore, the necessity of using macroprudential policy and its instruments also differs. Not only does the risk landscape differ from country to country, it is also constantly evolving. It is impossible to predict all the different risks that may arise in the future or to foresee in what part of the financial system they may emerge. Neither is it possible to develop all the tools that can handle all kinds of future risks.

**From this perspective, the framework for applying macroprudential instruments should be flexible enough to facilitate timely and adequate response to systemic risks, avoiding inaction bias.** Macroprudential tools must correspond with the volatile and unpredictable nature of the risks they are designed to address. This implies that instruments need to be highly flexible regarding the scope of exposures and/or institutions they can be applied to. Processes should also be streamlined to allow for the adequate and timely implementation of measures.

**Flexibility of macroprudential instruments means latitude for national authorities to deploy them.** National flexibility is already at the core of the current CRD/CRR framework. Currently, the primary responsibility for macroprudential policy lies with the national authorities, while EU institutions are envisaged only to provide necessary coordination and harmonisation. This set-up is sound and EU institutions should therefore refrain from reducing the room for manoeuvre for national macroprudential actions by imposing a pecking order for the use of instruments, setting caps and limits on instruments, or through cumbersome approval procedures.

**The current pecking order of instruments in the EU macroprudential framework impairs flexibility and induces inaction bias.** The present sequencing hierarchy is associated with a burdensome activation and notification procedure for some of the instruments, which can (further) induce inaction bias. The approval procedure for some of the macroprudential instruments involves a number of EU institutions, which can “make or break” a measure that is deemed necessary to manage identified systemic risks by the national authorities. In this context, cumbersome activation procedures, implying delays and even rejection of the intended measures, can counteract a swift implementation and by themselves cause inaction bias rather than promote a proactive use of macroprudential policy.

**There are examples where the current pecking order might complicate counteracting systemic risks.** Risks related to real estate exposures can serve as an example that a strict pecking order can cause unnecessary burdens for national authorities. If an authority wishes to increase risk weights to curb a potential house price bubble, a complex sequence of steps should be applied. First, under Pillar 1 (Articles 124 or 164 of the CRR), the authority must document that the current level of risk weights or LGDs is at odds with actual realized losses, future real estate market development or financial stability concerns. If the symptoms of a price bubble are not yet visible and actual loan losses are low, it is difficult to argue that these conditions are fulfilled. Next in line, the solution via Pillar 2 might be impaired by coordination difficulties, if the macroprudential authority differs from the competent authority, through the lack of a signalling effect when Pillar 2 is not made public and by the administrative burden and time delay when negotiating the issue in supervisory colleges. The measure of last resort, Article 458 of the CRR, is general enough in terms of instrument design but is hampered by long delays and administrative burden. The application procedure vis-à-vis the Commission and the Council requires extensive evidencing that such a measure is necessary and that the risks cannot be tackled by other instruments.



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### **Annex 3 – Delineation and alignment of the O-SII buffer and the SRB**

Under the current text of the CRD IV, long-term non-cyclical systemic risks are addressed by (i) the buffers for SIIs and (ii) by the SRB. The buffers for SIIs comprise the capital buffers for G-SIIs and the one for O-SIIs. The SRB and the O-SII buffer should serve different purposes and their simultaneous use for the same kind of risk should be avoided. A clear separation of the instruments and their application is furthermore a precondition for properly evaluating their effectiveness. The concept of delineation and alignment laid out in this annex means that the changes proposed for the O-SII and the SRB are to be seen as a package of mutually reinforcing amendments.

SII-buffers should be dedicated to mitigating the “too-big-to-fail” risks of individual institutions. The competent or designated authority in charge should identify G-SIIs on a consolidated basis and O-SIIs on an individual, sub-consolidated and/or consolidated basis, as applicable. The highest level of consolidation should apply within the global or domestic framework.

As the point of reference for the O-SII buffer is the financial system of the domestic economy or the economy of the European Union, it should be calibrated separately from the G-SII buffer, which has the global economy as its point of reference. This implies that the O-SII buffer rate could be set higher than the G-SII buffer rate, namely if the systemic risk posed to the domestic economy is higher than that to the global economy. The maximum rate of 2% for the O-SII buffer, compared with 3.5% for the G-SII buffer, is therefore not tenable in this regard.

The 2% cap of the O-SII buffer is also not adequate, as analyses based on an equal expected impact approach suggest that buffers for systemically important banks might need to be higher than 2%. Currently the SRB can be (and is being) used to top up the O-SII buffer, as the former is perceived as too low to mitigate the risk some institutions pose to the financial system. In fact, the cap sets an incentive for authorities to address too-big-to-fail risk by applying an SRB instead of the SII buffer in order to circumvent the cap. In practice, the cap thus contributes to the overlap between these instruments. Consequently, the cap should at least be substantially increased to ensure an appropriate level of national flexibility and allow authorities to adequately address the risk resulting from O-SIIs.

By the same token, the cap on the buffer rate of subsidiaries, which is set either at 1% or equal to the G-SII or O-SII buffer rates of the parent company (Article 131(8b) of CRD IV) is problematic and should be removed. First, the fact that a parent institution is not very systemically important (e.g. has a G-SII or O-SII buffer of 1%) does not preclude its subsidiary from being a dominant institution in a given country, warranting a much higher O-SII buffer than the 1% allowed in such a situation. Second, the cap raises level playing field concerns inside a Member State. The same buffer rate (higher than 1%) cannot be applied to two banks of similar systemic importance belonging to different ownership structures if one of them is a domestic bank and the other a subsidiary of an EU parent institution.

The increased discretion for national authorities to use the O-SII buffer without the cap would require better guidance for national authorities to reduce variation in the design and calibration of the O-SII buffer. An appropriate way forward would be an additional EBA guideline on the design and calibration of O-SII buffers, devised in cooperation with macroprudential institutions (e.g. ESRB) in order to ensure a level playing field and improve consistency and comparability in the application of the O-SII buffer, thereby also counteracting ring-fencing. The proposed guidelines should, inter alia, include provisions regarding the disclosure of the buffers applied and the underlying method that go beyond the current requirements. This should lead to a revision of the notification templates. More detailed information and disclosure seem to be warranted regarding the scores of the five categories

(not just the overall score) and about the reasoning for use and calculation methods of optional indicators used.

As the authority responsible for identifying G-SIIs or O-SIIs can be either the competent or the designated authority, some kind of notification or cooperation requirement between the two parties could enhance the consistency of the overall capital requirements.



## Annex 4 - Sectoral countercyclical capital buffer

The main instrument in the CRD IV/CRR aimed at addressing systemic risks of a general cyclical nature is the CCyB. The instrument is designed to support the sustainable provision of credit through the cycle by strengthening the resilience of credit institutions in buoyant times.

**The scope for applying targeted cyclical instruments within CRD IV/CRR to specific segments of the credit market is currently limited to exposures to residential and commercial real estate and intra-financial sector exposures.** Cyclical risks of a systemic nature related to any other credit segment can currently only be covered through the use of Pillar 2 for macroprudential purposes.

**A CCyB that can target specific segments of the credit market would allow a more targeted approach for addressing cyclical risks originating from a specific sector.** As with the broad-based CCyB, the purpose of a sectoral CCyB would be twofold: to increase banks' resilience in the context of excessive credit growth (in specific activities and/or segments) and, potentially, to "lean against the wind" and dampen the build-up of bubbles arising in specific segments.

**There is an insufficiently clear delineation between macroprudential and microprudential considerations in the existing CRD IV/CRR instruments that target real estate exposures.** Such a lack of conceptual clarity is inherent to instruments that operate through changing risk weights, in particular when targeting banks using internal models for determining risk weights, and may lead to divergent views on what the appropriate response to macroprudential risks is. The introduction of a macroprudential sectoral CCyB, which, for instance, separately addresses credit developments in the household sector, would usefully complement existing tools for real estate-related exposures. Moreover, it would overcome potential unintended effects on IRB banks' incentives present in existing instruments in CRD IV/CRR that operate through risk weights.

**In contrast to the activity-based measures (LTV/LTI/DSTI caps) currently available in national legislation, a sectoral CCyB can also be applied to the stock of existing loans.** A sectoral CCyB would thus allow banks' loss absorption capacity to be increased directly and immediately, thereby also mitigating potential risks stemming from the existing stock of exposures in specific credit segments.

**A key decision relates to what credit segments could be targeted by a sectoral CCyB.** Important in this context is whether these credit segments should be specified ex ante in legislation or left to the discretion of designated authorities, and whether authorities would be allowed to impose more than one sectoral CCyB level targeting different credit segments. These decisions involve a trade-off between risk coverage and national flexibility on the one hand, and complexity of the macroprudential framework on the other hand. In any case, the sectoral risk has to be of a systemic nature to justify activating a sectoral CCyB.

**Policy and communication strategies that specify a sectoral CCyB's interaction with the broad based CCyB would need to be developed.** In principle, the instruments would act as substitutes, with designated authorities selecting one of the two buffers, depending on the nature of the credit developments they are facing, as well as on whether or not first order losses are expected to be confined to the specific credit segment. Clear policy and communication strategies would be needed to help mitigate the clear communication challenges related to the activation of these two interacting and overlapping buffers.

**Safeguards should be in place to avoid any double-counting of capital requirements in case the systemic risk buffer (SRB) could also be applied to a subset of exposures.** To this end, what constitutes structural risk and cyclical risk would need to be clarified. This may be challenging in

practice, as those vulnerabilities identified may contain both a cyclical and structural dimension. Finally, also relating to the abovementioned design issues, additivity rules regarding sectoral CCyBs and broad-based buffers should be specified. These rules determine whether or not a sectoral CCyB could be activated in conjunction with the broad-based CCyB or SRB targeting the same credit segment.