ESRB
European Systemic Risk Board
European System of Financial Supervision

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Chair

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To:

The President and Members of the Economic and Financial Affairs Council (ECOFIN)
The President of the European Commission, Vice-President Rehn and Commissioner Barnier
The President of the European Parliament, the Chair of the Committee on Economic and Monetary Affairs, the Rapporteur and the Shadow Rapporteurs on CRR/CRD

Principles for the development of a macro-prudential framework in the EU in the context of the capital requirements legislation

Dear Sir/Madam,

The EU institutions are working to reform the prudential supervision of banks through the Capital Requirements Regulation and Directive (CRR/CRD). With this letter, the ESRB seeks to convey to you and the broader public some principles regarding these reforms from a macro-prudential angle. It hopes that these principles will assist legislators in further developing the basis for macro-prudential actions within the CRR/CRD and in finalising the reforms.

The CRR/CRD reforms arise from the Basel III Agreement and the report of the de Larosière Group, which recommended a single rule book for the supervision of banks and the establishment of a macro-prudential framework. Also from a macro-prudential perspective, the ESRB regards as essential a single rule book based on common definitions for both prudential methodologies and requirements across the Union, and on the full implementation of Basel III.

In pursuing these reforms, the diversity of our Union and the risks its economic and financial systems may give rise to must hold centre stage. Policies must be commensurate with the scale and evolution of future threats at both EU and Member State level, and biases toward inaction must be avoided. Under a single rule book, this approach to risks requires a framework that permits constrained discretion, with workable safeguards, for macro-prudential authorities at both Member State and Union level to tighten calibrations (while leaving definitions untouched) of commonly-defined prudential requirements. This was advocated also by the de Larosière Group (Recommendation 10) and is consistent with advice to the G20 by the Financial Stability Board, International Monetary Fund and the Bank for International Settlements.

Furthermore, the macro-prudential framework must be designed to tackle systemic risk, which includes risks from a wide range of sources: from within the financial system (given intra-system interconnections and contagion between banks, and between banks and others including non-regulated entities or 'shadow banks'); from the system to the real economy; and from strong feedback mechanisms between the two.

The ESRB has identified three principles to underpin such a framework: flexibility, scope to act

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early and effectively, and efficient coordination consistent with a 'constrained discretion' approach to macro-prudential policy in the EU and its Member States.

First, authorities will require ***flexibility*** in the set of available policy tools to both prevent and mitigate specific risks. Macro-prudential authorities at both Member State and Union level need discretion to require additional disclosures and to tighten temporarily a diverse range of (Pillar I) calibrations: for broad requirements, such as aggregate capital levels, liquidity requirements and limits to large exposures and to leverage; and for more targeted requirements, such as sectoral capital requirements to address specific vulnerabilities (e.g. household, corporate, real estate, intra-financial system) across the different parts of banks' balance sheets (banking and trading books) in order to limit arbitrage. The ESRB is working to develop macro-prudential tools further and, where they are used also for micro-prudential purposes, on ways to ensure consistency.

Second, macro-prudential policy must have the ***scope to act early and effectively*** before the build-up of significant imbalances or unstable interconnections, having regard for unintended consequences. This requires a framework that supports the use of the most effective policy tools, for a given risk, in a pre-emptive, timely and efficient manner. Exposures to the same risk must be treated consistently: where institutions exposed to a risk in one Member State are regulated by other Member States, provision should be made for, at least, the voluntary mutual recognition of policy measures between the States concerned.

Finally, discretion to pursue macro-prudential policies in these ways requires ***efficient coordination*** as a safeguard to limit possible negative externalities or unintended effects for the sustainability of the single market in financial services or for the economies of other Member States. However, *tightening* calibrations imposes short-term costs also on *initiating* Member States, with *positive* stability externalities across the Union. That calls for ex-ante exchange of information and coordination, rather than for an authorisation procedure by a European body. Without any prejudice to the role of the Commission under the acquis communautaire, competence for this coordination lies with the ESRB as the Union's macro-prudential overseer.

The ESRB is working out procedures which would support efficient ex-ante coordination, on the basis of advance notification to the ESRB of proposals for macro-prudential action to tackle risks, and with discussions in parallel with the national approval processes as appropriate. Where the ESRB determines that the risks that led to stricter prudential requirements are not justified or cease to exist, the ESRB would issue a recommendation to the Member State in question to remove or adjust the measure. In case of an inadequate follow-up to that recommendation, the ESRB would recommend to the European Commission that it considers appropriate action.

This letter will be published on the ESRB's website on Monday 2 April 2012.

Yours sincerely

Mario Draghi