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The macro-prudential mandate of national authorities

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Macro-prudential policy is an integral ingredient of any policy framework to address the stability of the financial system as a whole. The practical implementation of macro-prudential policy requires a clear institutional framework with adequate flexibility – both at the European Union and national levels. A strong macro-prudential mandate is necessary to give authorities incentives and powers to address systemic risks. While the debate on the practical arrangements for macro-prudential policy is still ongoing, national governments currently building a macro-prudential policy framework have various options to choose from. The Commentary describes five guiding principles for the design of effective macro-prudential mandates. These principles also form the basis of the European Systemic Risk Board (ESRB) Recommendation on this topic published on 16 January 2012.

Keywords: European Systemic Risk Board, ESRB, macro-prudential mandate, systemic risk, macro-prudential supervision and regulation, macro-prudential policy, recommendation

1 INTRODUCTION

In response to the financial crisis, identifying and reducing the risks to the financial system as a whole has become a priority for policy-makers. A broad consensus has emerged on the need for macro-prudential policy, which seeks to limit system-wide risks. The next step is the practical implementation of macro-prudential policy. As a starting point, this requires the presence of an adequate institutional framework.

With the establishment of the European Systemic Risk Board (ESRB), an institutional framework for macro-prudential policy has been put in place at the European level. The ESRB has a legal responsibility for systemic oversight and the prevention and mitigation of systemic risks to the European Union (EU)

* From Oesterreichische Nationalbank and De Nederlandsche Bank, respectively.

financial system. However, macro-prudential policy also has an important national component. First, because systemic risks can arise at the national (or sectoral) level, as financial cycles and the structural characteristics of financial systems typically differ between countries, and thus may require a different policy response. Second, because the responsibility for the adoption of the measures necessary to maintain financial stability – either upon the initiative of the national macro-prudential authority or as follow-up to ESRB recommendations and warnings – lies first within national frameworks. The ESRB does not have the power to use macro-prudential instruments directly. Moreover, financial crises typically have a substantial impact on national public finances. Therefore, the effectiveness of macro-prudential policy in Europe depends not only on the institutional structure at the EU level, but also on the institutional frameworks and policy mandates at the level of individual Member States.

2 THE NEED FOR MACRO-PRUDENTIAL MANDATES

Before the crisis, a **specific mandate** for macro-prudential policy **was lacking** in most EU Member States. While central banks, financial regulators and finance ministries all played a role in shaping financial stability policies (i.e. based on their respective mandates), in most jurisdictions, there was no authority "paid to worry" about risks to the financial system as a whole and vested with sufficient powers to address these risks.

It is now recognised that **macro-prudential policy plays a crucial role** in filling this void. However, exactly how this should be implemented is still relatively unknown territory for policy-makers and central bankers alike. A condition for the effective implementation of macro-prudential policy is a well-defined policy mandate that aligns the incentives and instruments of the relevant authorities with the objectives of macro-prudential policy.

The objective of macro-prudential policy is to contribute to **safeguarding the stability of the financial system as a whole**, including by strengthening its resilience and decreasing the build-up of systemic risks, while ensuring a sustainable contribution of the financial sector to economic growth in the medium to long run. More specifically, macro-prudential policy seeks to address both the inherent procyclicality of the financial system (the time dimension of systemic risk) and the risks due to the direct and indirect linkages between financial firms and the distribution of risk (the cross-sectional dimension). This objective differs from that of other policy areas, such as monetary policy, and micro-prudential regulation and supervision. The latter is focused on institutions and ultimately aims at protecting depositors, investors and policy-holders; a distinction which warrants a separate legal mandate for macro-prudential policy.

When **defining an institutional mandate**, the specific nature of macro-prudential policy must be taken into account. Two characteristics are especially relevant in this respect. First, macro-prudential policy could suffer from an **"inaction bias"**: because it aims to secure a more stable financial system and a lower incidence of financial crises, the success of macro-prudential policy is hard to observe and can only be determined in the long run. The costs of macro-prudential policy measures, however, will be felt immediately. For example, demanding higher capital buffers from banks may make credit more expensive in the short run, whereas the benefits in terms of increased financial system resilience are difficult to measure. As a result, macro-prudential policies dampening the financial cycle may be unpopular in an upswing and justifying policy changes will be difficult. Without a strong mandate and clear channels of accountability, this could create an incentive for the policy-maker not to take action. Pressure from the financial industry, political bodies and also economists claiming that "this time is different" may exacerbate any such bias further.

The second characteristic of macro-prudential policy of relevance here is the **need for coordination across policy areas**. Financial stability is affected by macroeconomic policies and financial regulation and supervision, as well as the interaction between these policies. In practice, macro-prudential policy tools mostly take the form of micro-prudential instruments that are used for systemic purposes, and mitigating a specific systemic risk may require the use of tools from different policy areas. Financial stability is therefore a responsibility involving actions from different authorities and some form of coordination is essential. The necessity of coordination, however, does not imply that responsibilities should be less clearly defined. On the contrary, the risk that the need for coordination may reinforce the inaction bias underlines the crucial importance of a clear macro-prudential mandate.

3 A "BEST PRACTICE" MACRO-PRUDENTIAL MANDATE

Developing a coherent policy framework is a challenging task, both in conceptual and practical terms. The institutional structure and regulation for macro-prudential policy has to provide a capacity for action. This implies that the national macro-prudential authority must have a clear objective, be shielded from outside pressures, and have a medium to long-term policy horizon. Moreover, it must be held accountable for both taking action and not taking action in response to the systemic risks it identifies. To make this framework effective, careful thought must be given to the institutional set-up and to international coordination according to the five "guiding principles" below as recommended by the ESRB (**see Box 1**).

Objective – clear mandate to enhance accountability and reduce the risk of political pressure

First, the objective of macro-prudential policy should be clearly set out to ensure that there is no ambiguity about the **macro-prudential authority's role and responsibilities**. The general objective to promote systemic stability should encompass decreasing the build-up of systemic risks and increasing the risk-bearing capacities of the system, thereby ensuring a sustainable contribution of the financial sector to economic growth. Given that the ultimate objective of macro-prudential policy is difficult to quantify, accountability may be considered in terms of **achieving intermediate objectives** addressing vulnerabilities or key amplification channels (e.g. resilience to excessive credit and leverage or maturity mismatch).

The complexity of the processes that can generate systemic risk and the ease with which risks can migrate across the financial system call for a focus on the whole range of financial institutions, products, markets and infrastructures. The macro-prudential authority should therefore have a **broad mandate** to pursue financial stability **covering all segments of the financial sector**. This should help the national macro-prudential authority to overcome the bias towards inaction, as it legitimises policy measures and makes the authority accountable.

Institutional arrangements – one size does not fit all, but central banks should play a leading role

The institutional architecture is a core element of macro-prudential policy[1]. The choice of a specific institutional set-up depends on the prevailing financial structure, policy regime and other historical and political factors.

[1] For more details, see "Macroprudential Policy: An Organizing Framework", IMF, March 2011.

The **designated authority** should ideally either be a single institution or a board composed of representatives of all the institutions responsible for financial stability. The purpose of such an arrangement is to avoid any confusion over which particular institution is responsible for macro-prudential policy. In any case, **central banks** should play a **leading role** given their expertise in macroeconomic analysis and their existing responsibilities in the area of financial stability. Central banks can help realise greater clarity about the benefits and costs of macro-prudential policies. They also bring reputation and independence. Furthermore, central banks have strong institutional incentives to ensure that macro-prudential policies are effective, as this will lower the probability of having to undertake costly corrective measures in the future.

Last, but not least, the implementation of macro-prudential policies requires an appropriate **coordination mechanism** with other authorities in order to better handle overlaps with other policy areas. Such cooperation should also take into account the cross-border dimension.

Tasks, powers and instruments – creating a comprehensive analytical framework and a consistent set of policy tools

Macro-prudential policy requires a capacity to identify systemic risks early enough such that action can be taken to support financial stability. This encompasses the tasks of monitoring and assessing systemic risks and of developing and implementing policies to address these risks.

In fulfilling its tasks, the authority should have the **power to require and obtain all of the necessary statistical and financial information**, including institution-specific information from financial supervisors and information from outside the regulatory perimeter. To this end, effective mechanisms for the exchange of information between macro and micro-prudential authorities should be established.

The macro-prudential authority should also have access to **suitable instruments** in order to fulfil its mandate[2]. Otherwise it may be unable to respond effectively to emerging risks in the financial system. Instruments may include both those that can affect cyclical risks, such as unsustainable levels of leverage, maturity mismatch and credit growth, and those that can affect the structure of the financial system. An institutional separation between legally **non-binding and binding instruments** both in the form of warnings and recommendations could be provided for.

Transparency and accountability – prerequisites for good governance

As the effect of macro-prudential policies cannot be observed directly, a **clear and transparently communicated strategy** that sets out authorities' intentions serves as the basis for accountability. Decisions and the decision-making process should be transparent – unless confidentiality is warranted for financial stability reasons. This will contribute to informed expectations on the part of financial market participants and permit the private sector to correctly price-in risks and potential macro-prudential responses.

[2] Taking into account the possible impact of the ongoing EU reform of the capital requirements framework for credit institutions, the procedures for assigning instruments to the macro-prudential authority should allow – according to the principles of the relevant legislative framework – for timely adjustments of the policy toolkit in response to innovation and change within the financial system.

In particular, authorities should ensure that macro-prudential policy strategies, as well as their **decisions and the respective motivations** are made public in a timely manner (unless this would pose a risk to financial stability). Public accountability can be further increased by explaining the rationale of the use of macro-prudential instruments.

Finally, the authority should ultimately be **accountable to the national parliament** for its assessments of systemic risk and for its use of instruments in relation to its objectives.

Independence – strengthening credibility

In order to safeguard policy credibility, macro-prudential policy decisions should be shielded from outside pressures, in particular from the financial industry and/or political bodies. The macro-prudential authority should therefore be **operationally independent**. Pressure can be put on macro-prudential policy-makers against the tightening of policy in a boom ("taking away the punch bowl"), and towards excessive loosening or against further tightening of policy (required to mitigate the probable materialisation of risks) in a bust. It is equally important that operational independence in other policy areas – including monetary and micro-prudential policy – should not be undermined in the name of macro-prudential policy.

Finally, **international coordination** can often increase the effectiveness of policies taken at the national level. While tackling risks at the national level can also have positive effects on other countries by reducing the potential likelihood or severity of financial stress, measures taken by a national authority may affect business abroad, resulting in the need to take account of such cross-border spillover effects. A formal coordination mechanism for ensuring cooperation must be searched for to reduce the scope for international arbitrage that may otherwise undermine the effectiveness of national policies, for example, when tight requirements on domestic banks lead to an increased provision of credit by foreign lenders.

BOX 1: THE RECOMMENDATIONS OF THE ESRB

On 22 December 2011 the **General Board of the ESRB adopted a Recommendation regarding the design of policy frameworks** that advises Member States to enshrine the responsibility for macro-prudential policy in their national legislation, which was subsequently published on 16 January 2012 (see www.esrb.europa.eu).

In particular, the ESRB recommends **"guiding principles" for a national macro-prudential mandate** in respect of:

- **the objective** (Recommendation A);
- **the institutional arrangements** (Recommendation B);
- **tasks, powers and instruments** (Recommendation C);
- **transparency and accountability** (Recommendation D);

- **independence** (Recommendation E).

The recommended guiding principles should **be in force on 1 July 2013.** To this aim. Member States have to submit an interim report to the ESRB **by 30 June 2012** on the progress made regarding implementation, including an assessment for each specific guiding principle. A **final report is due by 30 June 2013.** The ESRB will monitor the implementation process over time and provide guidance as needed.

4 THE WAY FORWARD

Many EU countries are currently in the process of setting up an institutional framework for macro-prudential policy **(see Box 2)**. In order to stimulate the creation of stable and effective policy frameworks, the ESRB has issued recommendations on core elements of national macro-prudential mandates. These are meant to define "best practice" when it comes to national mandates for macro-prudential policy and serve as a benchmark for national authorities. However, a one-size-fits-all approach is inappropriate as the optimal design of national mandates depends on country-specific characteristics, such as the existing supervisory architecture. The ESRB Recommendation of 22 December 2011 acknowledges this and provides national authorities with general principles that can be tailored to their specific national situation. The effectiveness of macro-prudential policy in Europe will depend crucially on the national macro-prudential policy frameworks of Member States and on the proper coordination of these policies by the ESRB, not only across the EU but also with international organisations and the relevant authorities responsible for macro-prudential oversight in third countries.

BOX 2: THE INSTITUTIONAL SET-UP – SOME RECENT COUNTRY EXAMPLES

In **Hungary** the **Financial Stability Council**, consisting of the Minister of Finance, the Governor of Magyar Nemzeti Bank (MNB) and the Chairman of the Hungarian Financial Supervisory Authority (HFSA), started operating in January 2010. The chairmanship rotates every year. The Council has been set up to deal among relevant parties with issues related to systemic stability. Whenever the ESRB issues warnings or recommendations relevant for the Hungarian financial system the Council discusses prospective future steps in this regard.

Since 1 April 2011 the **National Bank of Belgium (NBB)** is **in charge of macro-prudential, systemic and micro-prudential supervision** (with the exception of conduct supervision). The NBB is responsible for ensuring financial stability by (i) screening the markets for possible threats to the financial system; (ii) advising the Belgian government and parliament on measures to ensure financial stability; (iii) co-ordinating the management of financial crises; and (iv) co-operating with European and international institutions and organisations, in particular with the ESRB. The NBB also performs macro-prudential supervision of "system-relevant" financial institutions. It is empowered to oppose those strategic decisions of these system-relevant institutions that are not compatible with a healthy and prudent policy or that may have a severe negative impact on financial stability and may also impose on the system-relevant institutions specific measures, such as additional solvency or liquidity requirements.

In **France** a **Council of Financial Regulation and Systemic Risk** was established in October 2010, chaired by the Minister of the Economy. It is composed of the Governor of Banque de France (BdF), the Vice-President of the Prudential Supervisory Authority (PSA), and the Presidents of the Financial Markets Authority and the Authority of Accounting Standards, and three other competent individuals. The Council's tasks are to (i) foster cooperation between its member institutions, (ii) analyse systemic risks in the financial sector and financial markets, taking into account recommendations and warnings from the ESRB, and (iii) to facilitate cooperation or take positions on matters related to European and international rules applicable to the financial sector.

In February 2011 an **interim Financial Policy Committee (FPC)** was established within the **Bank of England**. This was charged with responsibility for macro-prudential policy ahead of a proposed new statutory body. The interim FPC is chaired by the Governor of the Bank of England and its members include Bank executives, the Financial Services Authority (FSA) Chairman and Chief Executive (following the enactment of legislation, the FSA seats will be filled by the heads of the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA)), independent external experts and a representative from HM Treasury. The FPC will be given a set of macro-prudential instruments, yet to be determined, for which it will have the legal power to direct implementation. It will also be able to issue recommendations, including on an “comply or explain” basis, to the PRA and the FCA. In addition, it will be empowered to make recommendations to HM Treasury on the regulatory perimeter.

At the beginning of 2012, **Sveriges Riksbank** and **Finansinspektionen**, the Swedish Financial Supervisory Authority, created the **Council for Cooperation on Macro-prudential Policy**; a platform for discussing risk assessments and questions regarding macro-prudential policy jointly. The Council members are the Governor of Sveriges Riksbank, the Director General of Finansinspektionen, one of Sveriges Riksbank’s deputy governors and the head of its Financial Stability Department, as well as the chief economist and chief legal counsel of Finansinspektionen. The Council is a **temporary arrangement** in anticipation of a more permanent institutional framework for macro-prudential policy, which is currently being looked into by a special government commission.