

## Special Feature B: Development of the concept of macroprudential stance<sup>169</sup>

**The regular deliberations on the annual Review of Macroprudential Policy in the EU have consistently highlighted the need to develop a conceptual framework to support the discussion on macroprudential policy measures.** In addition to promoting a common understanding, such a framework is seen as useful in improving the communication of implemented macroprudential policies and aims to help anchor expectations about systemic risk developments and future policy actions. Furthermore, such a framework may help overcome potential policy inertia in the face of rising financial stability risks. Against this background a mandate for a working group was established by ESRB member institutions with the aim of developing a first step towards a common framework for the macroprudential stance. Consequently, the ESRB's Instruments Working Group (IWG) its Expert Group on Macroprudential Stance prepared a report which outlines the initial considerations on the features of a macroprudential stance. This special feature provides a brief synopsis of the main concepts discussed in the report.<sup>170</sup>

**The macroprudential stance establishes the relationship between macroprudential actions by policymakers and the objective of financial stability.** The aim of the macroprudential stance assessment is to provide information on the extent to which macroprudential actions are sufficient and help achieve the financial stability objective within a changing risk environment.

**The development of a framework for assessing the macroprudential stance is, however, challenging.** Macroprudential policy is multi-dimensional both in terms of intermediate objectives and instruments, as well as financial sub-sectors, and it is difficult to identify clear and well-defined policy goals which are linked to metrics and potential target levels. Furthermore, given the early stage in the experience with and understanding of macroprudential policies, the development of a fully-fledged measure of the macroprudential stance will rely on the experience gained over the coming years.

### B.1 A framework for the macroprudential stance

**One possible way in which to define a macroprudential stance is to consider a risk-resilience framework.** This framework would consider the assessment of gross systemic risk, accounting for available resilience in the economy and the financial system and then assessing the extent to which macroprudential policy instruments counter gross systemic risk or provide resilience. The relationship between systemic risk, resilience and macroprudential instruments can be conceptually depicted within a stylised risk-resilience framework (see Chart B.1).

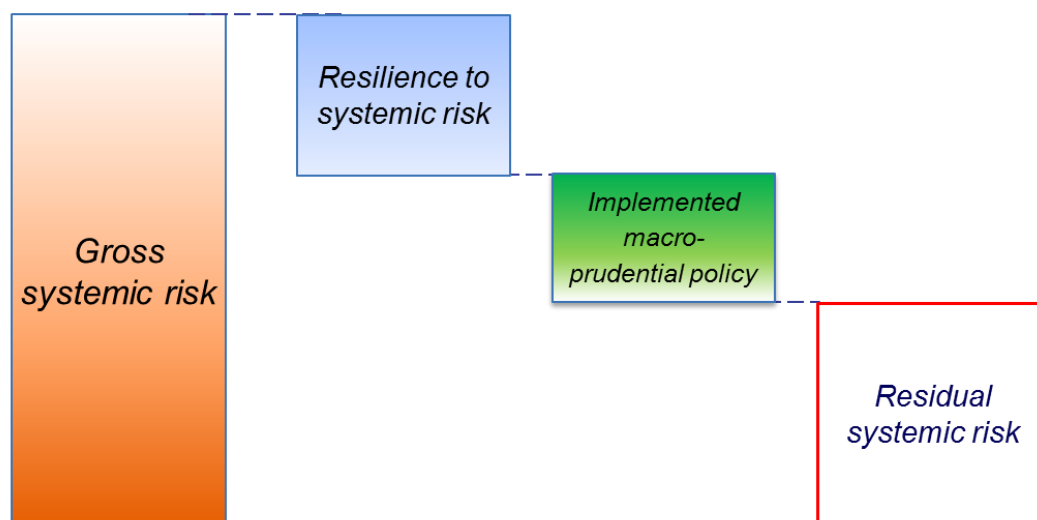
<sup>169</sup> Prepared by Stephan Fahr (ECB), Christian Gross (ESRB Secretariat), Niamh Hallissey (Central Bank of Ireland) and Jean Quin (ESRB Secretariat).

<sup>170</sup> See **Features of a macroprudential stance: initial considerations**, ESRB, Frankfurt am Main, April 2019.



Chart B.1

**Risk-resilience framework for the assessment of the macroprudential stance**



Source: Expert Group on Macroprudential Stance.

Note: This is a stylised example for illustrative purposes and the relative size of the boxes is not meant to indicate the relative importance of any of the risk-resilience components.

**The orange bar represents the gross systemic risk faced by the financial system and the economy.** Gross systemic risk is a combination of macro-financial vulnerabilities or fragilities that may be a source of shock or systemic threat to the financial system. Vulnerabilities are the economic and financial conditions which would lead to amplifications should targeted shocks affect the vulnerable dimensions of economic agents. Externalities relating to strategic complementarities, fire sales and interconnectedness are sources of financial vulnerabilities, leading to an endogenous build-up of systemic risk, in particular in times of high uncertainty in financial markets. It should be noted that gross systemic risk may vary over time; however, a stance assessment takes place at a given point in time and therefore Chart B.1 provides a snapshot.

**Resilience (blue bar) depicts the ability of the financial system and the economy to absorb the fallout when shocks and systemic risks materialise.** In the context of the macroprudential stance framework, components that determine resilience to systemic risk include microprudential provisions targeting institution-specific loss absorption, public system-wide safety nets such as deposit insurance, and institutional features such as resolution funds.

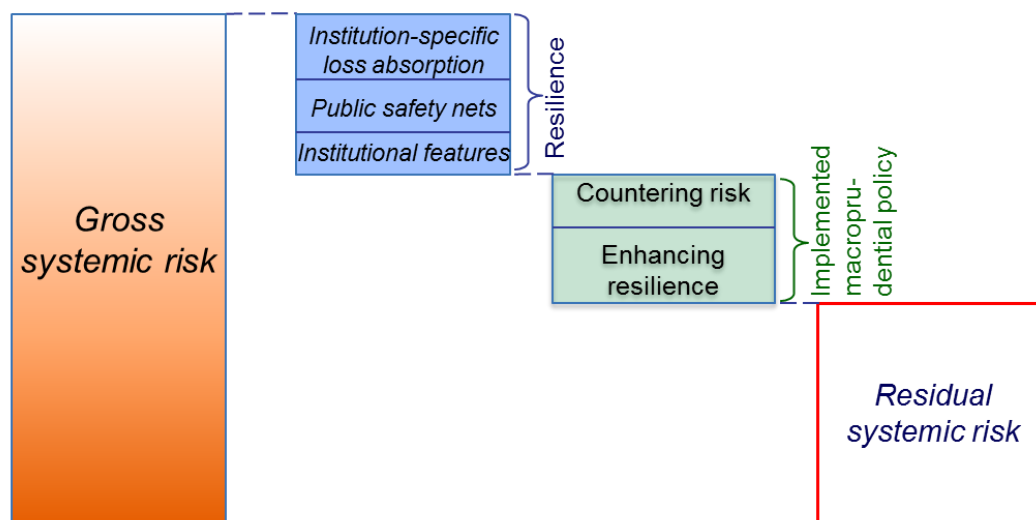
**The third component of the risk-resilience framework is the contribution of implemented macroprudential policies to addressing gross systemic risk and to raising resilience (green bar).** These macroprudential policies can build resilience, e.g. in the form of capital or liquidity buffer requirements, or can mitigate risks by restricting exposures or lending conditions or by guiding behaviours and expectations.

**Relating the amount of gross systemic risk to the available resilience in the system, including implemented macroprudential policy, gives an indication of the level of “residual systemic risk” (white bar with red frame).** The risk-resilience framework considers the level of identified gross systemic risk relative to the availability of resilience within the economy and the financial system, while accounting for the appropriateness and effectiveness of macroprudential policy. A larger amount of this net residual systemic risk indicates that the gross systemic risk exceeds the available resilience and the implemented policies to a larger extent.



Chart B.2

**Risk and resilience net of macroprudential policy impact**



Source: Expert Group on Macroprudential Stance.

Note: This is a stylised example for illustrative purposes and the relative size of the boxes is not meant to indicate the relative importance of any of the risk-resilience components.

**The three components of gross risks, resilience and policy are portrayed separately in an effort to distinguish contributions to the stance.** It is understood that these components may not always be cleanly separated and may overlap in practice. For example, Chart B.2 presents a modified illustration of the risk-resilience framework in which macroprudential policy is netted into systemic risk and resilience parts to highlight the interaction between macroprudential policy, systemic risk and resilience. Chart B.2 illustrates, in a stylised manner, that macroprudential policy can either counter systemic risks directly, thus reducing the gross amount of systemic risk, or it can enhance overall resilience in the system. In order to structure policy discussions in macroprudential fora, the framework portrays the residual systemic risk component as a linear function of the three components. It should be borne in mind that this conceptual simplification is used purely for illustrative purposes and abstracts from the complex non-linear interactions observed in reality.

**Using this risk-resilience framework, the macroprudential stance can be assessed as the difference between the observed level of residual systemic risk and a benchmark level of risk (a neutral level).** The neutral level is considered to be the level of overall risks that the policymaker has tended to accept and which remains not covered by macroprudential policies or the overall available resilience.

**If the residual systemic risk level exceeds the neutral level, this implies that the current macroprudential stance is loose; if the level of residual systemic risk is lower than the neutral level, the stance is tight.** For a loose stance, implementing macroprudential policies either through risk-mitigation policies or resilience-building policies would reduce the gap between risk and resilience and bring the macroprudential stance back towards the neutral level. If the stance is considered tight, the ability of the financial system to provide products and services to the real economy may be curtailed excessively in the considered economic and financial environment. In turn, once shocks materialise, the systemic risk component declines and the macroprudential resilience mechanisms absorb the fallout. This would warrant the release of macroprudential instruments.



## B.2 Macroprudential stance and policy action

**The risk-resilience framework is a relative concept and provides policymakers with a choice between acting by addressing gross systemic risks or by adjusting resilience.** The stance assessment itself does not identify the necessary course of action. A non-neutral macroprudential stance thus requires a separate assessment by policymakers on how best to address the level by targeting risks and/or by adjusting resilience.

**The stance assessment is a point-in-time assessment which takes into account implemented policies and involves assessing risks and the need for policy action.**<sup>171</sup> Only with the information on the exposures to types of risk, the resilience across sectors and the effectiveness of macroprudential instruments in countering risks and enhancing resilience can the policymaker assess which types of policies could alter (reduce or increase) the stance towards its neutral level. Once policy action has taken place, the stance will change and a new stance assessment can then be carried out in the future to include potential adjustments of the economy and the financial system.

**The policy stance assessment does not attempt to identify an optimal target for macroprudential policy; rather, it forms the basis for considering “policy action”.** Chart B.3 illustrates how the stance assessment serves as input to the policy assessment. As previously portrayed in the discussion on the risk-resilience framework, a neutral stance implies that the implemented policies are considered sufficient to pursue the macroprudential policy objectives and no further action is required (unless a suboptimal mix of instruments and policies is in place; in this case, even a neutral stance could require further policy action). If, instead, the macroprudential stance is assessed to be tight or loose, further policy action could be considered. While the stance assessment itself focuses on describing the environment as loose, neutral or tight, additional information on the nature of any change compared with a previous period may help to guide policy actions.

**A policy action assessment would consider short- and long-run costs and benefits of adjusting the calibration of macroprudential instruments, either in terms of a release or a further tightening, depending on the policy stance assessment outcome.** In addition, the policy action assessment takes into account the appropriateness and relative effectiveness of individual instruments for reaching the specified macroprudential objective. In relation to other policy areas, macroprudential policy can, on the one hand, mitigate financial stability risks generated by other policies (e.g. low monetary policy rates increasing risk-taking, or the lack of a fiscal backstop) or, on the other hand, where there are complementarities between macroprudential policy and other policies, changes in other policies may result in stronger or weaker calibrations for the macroprudential instruments.

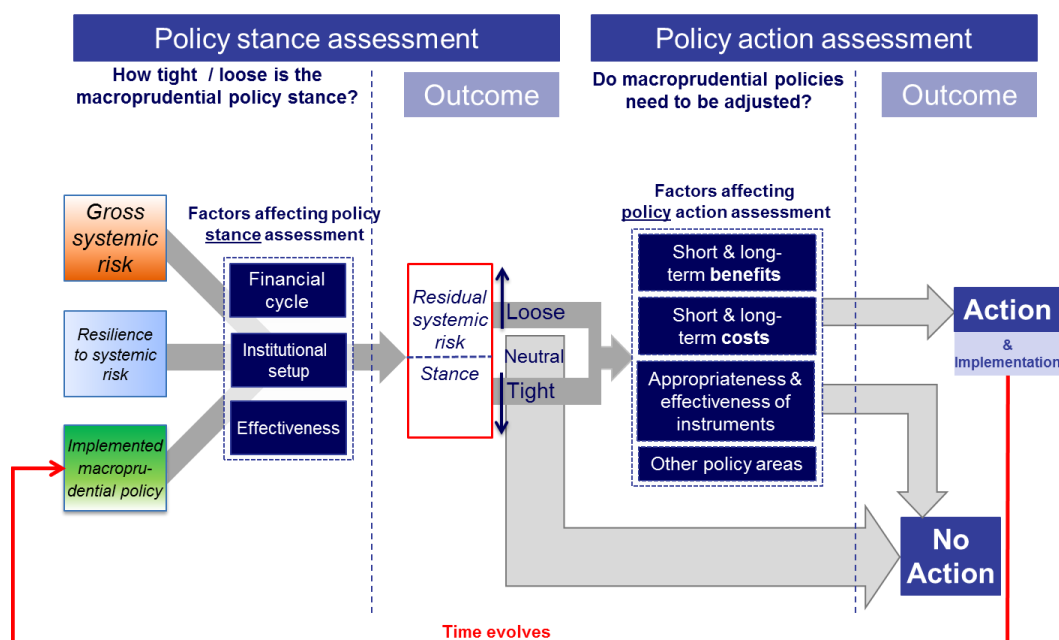
**Depending on the result of the policy assessment, a policymaker may decide if and what action should be taken.** It is possible in this framework to have a loose macroprudential policy stance without additional policy action being taken if policymakers conclude that the overall costs of further action outweigh the benefits.

<sup>171</sup> In this framework, the stance assessment of implemented policy measures is separated from the assessment of costs and benefits of potential adjustments to macroprudential policy.



Chart B.3

### The assessment of macroprudential stance and policy action



Source: Expert Group on Macroprudential Stance.

Note: This is a stylised example for illustrative purposes and the relative size of the boxes is not meant to indicate the relative importance of any of the risk-resilience components.

## B.3 Factors affecting the stance and policy action assessments

**Fundamental to the macroprudential policy framework is the role of policymakers' judgement of risks and resilience; judgement is therefore a key feature for the assessment of the macroprudential stance and the subsequent assessment of policy actions ("inaction bias").** There are a number of factors affecting the policy stance and policy action assessments which policymakers ought to consider, including their judgement of risks and resilience, the position of the financial cycle, policy preferences and interactions of macroprudential instruments with other policies. The two-tier process explicitly allows for an assessment of a non-neutral and macroprudential policy action that would not fully bring the residual systemic risk to its neutral level.

**Multiple factors may prevent policymakers from taking policy action, even though the macroprudential stance assessment indicates a non-neutral stance.** The lack of an appropriate instrument, combined with the absence of adequate alternative instruments to address the identified risk, would lead to the absence of policy action. It is also worth noting that whilst datasets for macroprudential purposes are continuously evolving, knowledge gaps remain in relation to systemic risk and its transmission channels, thereby generating uncertainty in the stance assessment, which could result in policy action not being taken. The fact that the benefits of macroprudential policy materialise after some delay and that the costs are more immediately visible makes short-term calculations of the net benefits difficult, which could in turn delay or even impede policy actions. Linked with this there could be uncertainty about the transmission and effectiveness of policy instruments. Short-run costs to particular groups in society may be obvious, whilst the potential benefits of macroprudential action would tend to come in the medium term and the beneficiaries may not be identifiable in advance, potentially creating inaction bias. Finally, the



interaction of macroprudential policy with other policy areas could imply strategic burden shifting and generate inaction on the part of macroprudential authorities.

**Beyond the judgement of policymakers, the relative choice when selecting policies that address gross systemic risks or adjust resilience is influenced by the position of the financial cycle as this has an impact on the relative costs and benefits of the policies in the short and medium term.** This raises an important policy question on the timing and the interplay of these two types of macroprudential policies: those that aim at enhancing resilience and those that aim at moderating the financial cycle. For instance, a relevant question is whether greater resilience is needed when the amplitude of the financial cycle is large compared with when it has been dampened by cycle-moderating macroprudential policy instruments. In addition, the emphasis on the two types of macroprudential policy instruments should vary over the financial cycle. In particular, resilience-enhancing macroprudential policies are likely to be most effective when losses in a crisis are expected to be large.

**Policy preferences matter for various elements of the macroprudential policy stance.** One aspect for which policy preferences may influence the stance assessment is the horizon over which the target has to be met. Policy lags can be understood as the time before policy measures become effective in countering risks or enhancing resilience. Longer policy lags mean that instruments have to be tightened or loosened more decisively to achieve the same policy stance. Another aspect is policy preferences regarding the volatility of the instrument versus the target. A macroprudential authority may have a preference for adjusting measures gradually in an attempt to reduce the economic cost of an increase in the buffer or when the inherent uncertainty in assessing the degree of risk to bank capital is a key concern. Preferences also inform the hierarchy of different (intermediate) targets and the selection of instruments.

**Macroprudential policy can interact with monetary policy and so the macroprudential stance is affected by the level of interest rates and liquidity conditions.** To assess the macroprudential stance, it is therefore important to take into account the implications for systemic risk of the overall conditions prevailing in the financial system. Whilst monetary and macroprudential policy have the capacity to influence both price and financial stability conditions, they remain distinct and separate policies.

**Macroprudential policy also has the capacity to interact with microprudential policy.** Micro- and macroprudential policies operate to a large extent through similar tools that affect the same variables (capital, liquidity, limits to exposure concentration, etc.), and therefore benefit from being coordinated.<sup>172</sup> Accordingly, it is the overall level of prudential requirements that affects banks' capacity to finance the real economy, which is particularly relevant in economies that rely heavily on bank credit such as the euro area. It could therefore be useful to think in terms of an "overall prudential stance".

**Other policies outside the remit of the macroprudential authorities may be accounted for in the macroprudential stance.** Economic policies do affect the risks and resilience of the financial system and thereby are relevant to achieving financial stability objectives, even if macroprudential authorities cannot influence these policies.

<sup>172</sup> See Alessandri, P. and Panetta, F., "**Prudential policy at times of stagnation: a view from the trenches**", *Occasional Paper Series*, No 300, Banca d'Italia, Rome, December 2015.



## B.4 Conclusion

**The concepts outlined in this special feature present some initial considerations on the development and use of a common framework for the macroprudential policy stance.** Such a framework, if successfully implemented, can help support macroprudential policymakers in their decision-making process to ensure sufficient and appropriately targeted macroprudential policies.

**It is envisaged that the work on the conceptual aspects of the macroprudential stance framework would be further developed into an operational framework over the medium term.**

Macroprudential authorities could use such a framework when conducting their assessment of risk and resilience and when analysing the appropriateness of their macroprudential responses. This requires the development of a quantitative concept which is transparent and flexible enough to allow and encourage implementation by national authorities.

**In order to further develop the concepts presented, institutional cooperation within the ESRB membership and working groups would be key.** It is envisaged that operationalising the macroprudential stance framework will have a significant and positive impact on the progression and understanding of macroprudential policy across Europe.

