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Welcome address

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An EU Legal Framework for Macroprudential Supervision
through Borrower-Based Measures

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Ladies and gentlemen,

This seminar takes place while the European Commission is working on improving the EU macroprudential framework for the banking sector. A legislative proposal may be submitted by the Commission to the European Parliament and to the Council in the first half of 2023. The purpose of this seminar is to stimulate a debate on the initiatives foreseen by the Commission in the field of borrower-based measures ('BBMs').

Allow me to start this discussion with a few considerations on the current situation, and some very tentative reflections about possible choices for the future.[1]

Macroprudential policy and monetary policy

Macroprudential policy has been defined as the use of primarily prudential tools to limit systemic risk.[2] Central to this definition is the notion of systemic risk—the risk of disruptions to the provision of financial services as a result of the impairment of all or parts of the financial system, which can cause serious negative consequences for the real economy. By mitigating systemic risk, macroprudential policy ultimately aims to reduce the frequency and severity of financial crises, contributing to overall macroeconomic stability. Macroprudential policy seeks to increase the resilience of the financial system to aggregate shocks by building buffers that absorb their impact, thereby preserving its ability to provide credit to the economy. It can limit the build-up of systemic vulnerabilities over time, by reducing the procyclical feedback between asset prices and credit developments and by containing unsustainable increases in leverage and volatile funding. In addition,

1 I wish to thank Emilia Bonaccorsi, Federica Ciocchetta, Wanda Cornacchia, Alessio de Vincenzo and Giuseppe Napoletano for their valuable input and comments.

2 IMF 2013, IMF-FSB-BIS 2016.

in the structural or 'cross-sectional' dimension, macroprudential policy can seek to control the build-up of vulnerabilities within the financial system that arise through both interlinkages between financial intermediaries and individual institutions playing a critical role in key markets, which can make them too important to fail.

To the extent that macroprudential policy reduces systemic risks and creates buffers, it helps monetary policy achieve its goals in the wake of adverse financial shocks. Thus, macroprudential policy can reduce the burden on monetary policy to 'lean against' adverse financial developments, thereby creating greater room for manoeuvre for the central bank to pursue price stability. In such circumstances, monetary and macroprudential policies reinforce each other in a rather obvious way.[3]

Circumstances, however, are not always the same. Monetary policy is common to all euro-area countries and markets and is necessarily conducted in a 'one-size-fits-all' manner. It may therefore have undesired side effects on specific markets, or countries, where specific conditions prevail. Macroprudential policy, on the other hand, can, by nature, be made more targeted to address such situations. When monetary policy is loose, for instance, macroprudential measures can be used to mitigate the risk of localised bubbles in certain markets. This is not just a theoretical possibility. In 2021, with monetary policy still very accommodating, several Member States tightened their macroprudential policies to mitigate the risk of localised overheating, especially (though not exclusively) in property markets. This condition does not mean that the two would then work against each other. On the contrary, as long as they are well coordinated, they are still complementary: in such a situation, macroprudential measures facilitate the use of monetary policy, which is more powerful and wide-ranging but also blunter, by mitigating its side effects-just as the targeted complementary probiotic that doctors sometimes prescribe can make an antibiotic treatment more effective.

Much of this tailoring has a geographical dimension, because market conditions differ across countries, owing e.g. to residual national regulation or persistent fragmentation in certain markets (e.g. bank lending); nothing more so, however, than measures targeting the real estate market, which is *inherently* defined by geography—a feature that no legal harmonisation can change. In the case of real estate, given the heterogeneity that may exist within countries, policy-makers may even want to consider measures to be applied on a sub-national basis. In general, national authorities seem to be best placed to evaluate the need for many macroprudential measures.

As long as fragmentation remains significant in the relevant markets, a key responsibility for initiating and calibrating macroprudential policy should therefore remain at the national level; for the real estate sector, fragmented by definition, this will probably always be the case. However, there needs to be a common framework, common rules and some centralised checks to ensure coordination, not least with monetary policy, to avoid unwanted spillovers, and to ward off ring-fencing.

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[3] Visco, 2014 and 2015.

Effectiveness of macroprudential policy

While macroprudential measures of some kind were occasionally used by supervisors even before the name existed, it is only since 2013 that a systematic framework for such measures has been available in the European Union. The situation is similar in other major jurisdictions. There is therefore only a limited amount of experience and data that research can draw upon to study its effectiveness in quantitative terms; the literature is not yet extensive. That said, what empirical evidence is available does suggest that macroprudential policy instruments, by and large, work as intended.

Various studies confirm that measures that restrict lending are generally effective in curbing house prices and credit growth.[4] The ECB has recently analysed the impact of capital buffer releases on bank credit supply in the European Banking Union during the pandemic, and found that capital relief measures had positive effects on lending, especially for banks that were close to the combined buffer requirement.[5] This finding supports the idea that releasing regulatory capital buffers during periods of stress can mitigate procyclical pressures in the banking system.

Capital-based measures make the banking system more robust by reducing banks' leverage and probability of default; BBMs do the same indirectly, by strengthening borrowers' resilience.[6] Income-based tools (the debt-service-to-income ratio, or DSTI, and the debt-to-income ratio, or DTI) mainly reduce the probability of default, while collateral-based tools (like the loan-to-value ratio, or LTV) act primarily through reducing loss given default. The effect is stronger when LTV, DSTI and DTI caps are imposed jointly. The adoption of more prudent lending standards as a result of BBMs has been found to improve the quality of banks' mortgage loan portfolios, thereby supporting the capital position of banks.

The empirical evidence, however, is not clear-cut in all respects. Some research finds little or no effects of BBMs on lending growth, house prices or household indebtedness.[7] Much depends on calibration. Sometimes policies are deliberately calibrated not to be binding at the time of adoption, but to prevent undesired developments later on.[8] Moreover, BBMs may affect specific groups, such as banks, borrowers or countries, even

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4 Cerutti et al., 2017; Eller et al., 2020.

5 Couaillier et al., 2021. The regulatory capital relief measures considered in the analysis include the reduction of the Combined Buffer Requirement (CBR), as well as the frontloading of new rules on the composition of the Pillar 2 Requirement (P2R), allowing banks to partly use Additional Tier 1 and Tier 2 (instead of CET1) instruments to meet these requirements. In particular, credit volumes increased by 3.1 per cent after the regulatory capital relief measures, while interest rates on loans to firms eased by 7 basis points.

6 Ampudia et al., 2021.

7 See, for Romania, Neagu et al., 2015.

8 This seems to have been the case with the UK Financial Policy Committee's decision in 2014 to recommend a loan-to-income (LTI) flow limit calibrated to a level that would have no impact on mortgage lending in a central scenario, but would prevent a significant increase in lending at very high LTI multiples (Bank of England, 2014; see also, for Poland, Łaszek et al. 2015).

when there is no clear overall effect. These heterogeneous effects are mainly attributable to the introduction of differentiated LTV limits by category of borrowers.[9]

While several papers investigating the effects of LTV or DSTI caps use a multi-country framework, and policy dummies or macroprudential indices to operationalise the definition of macroprudential policy,[10] single-country studies provide a more focused analysis on the impact of these measures. For instance, both one paper on Israel[11] and one on Sweden[12] found that the introduction of an LTV limit did not reduce the number of borrowers accessing credit; but it did encourage borrowers to borrow less and to buy cheaper and lower-quality houses.

There is also some evidence of unintended consequences, such as spillovers (banks shifting risk to other business areas), and circumvention. For example, when Ireland introduced LTV and LTI limits in February 2015, banks appear to have increased their risk-taking in lending to companies and holdings of securities, two asset classes not targeted by the measure.[13] In Spain, following a similar measure, appraisers appeared to have started to overvalue property in order to lower LTV figures on loan applications.[14]

Completing the legal toolkit

The current legal framework harmonises capital-based macroprudential measures. It establishes definitions and parameters, as well as rules and procedures for the allocation of responsibilities between national and European authorities. Such measures are subject to a system of EU-level surveillance and, in some cases, authorisations.

That system was set up at the very beginning of the European macroprudential experience. National authorities initiate the procedure for national measures. Within the euro area, the ECB reviews them and may ‘top them up’ (i.e. make them more restrictive), while it has no power to ‘level them down’.[15] The ECB has defined and published the procedure that it follows when reviewing the national measures.[16]

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9 A differentiated impact was observed in Israel (Tzur-Ilan, 2017) for the segment of the population investing in housing (but not for primary residence), with a sharp reduction in the value of houses bought after different LTV limits were imposed on different categories of buyers (first-time buyers, non-first-time buyers and investors who own two or more homes). Similarly, in Ireland (Kinghan et al., 2016a and 2016b), the introduction of differentiated LTV caps had heterogeneous effects based on borrower income.

10 See for instance Cerutti et al., 2017; Ahuja and Nabar, 2011.

11 Tzur-Ilan, 2017.

12 Bentzen et al., 2018.

13 Acharya et al., 2018.

14 Montalvo and Raya, 2018.

15 Article 5(2) SSM Regulation (Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, p. 63).

16 Regulation of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17), Articles 101-105 (OJ, L 141, 14 May 2014, p.1).

In contrast, BBMs are not harmonised in the relevant legislation. They are thus left to national discretion, in terms of both design and calibration. I have just argued that the case for maintaining the main responsibility for macroprudential policy at the national level is even stronger for measures targeting the real estate market. However, there may also be a case for some degree of coordination or, at least, harmonisation of definitions and statistical reporting requirements.

The European Systemic Risk Board (ESRB) has already taken certain steps in this direction. Since 2013, the ESRB has listed LTV, LTI and DTI requirements among the instruments that can be used to prevent and mitigate excessive credit growth and leverage.[17] In 2019, the ESRB issued a Recommendation on closing real estate data gaps to provide guidance on the methodology underlying common indicators, specifically targeting the residential real estate market.[18]

Notwithstanding those initial steps, laws and practices still differ considerably within the EU. The Commission observes in its Consultation document that "[w]hile several Member States are already using BBMs based on national law, a complete set of BBMs is not available in all Member States. This could affect the ability to address systemic risk and create cross-country inconsistencies and difficulties with reciprocity".[19] At the very least, as the ESRB recently stated, common rules on BBMs "could increase the transparency and comparability of macroprudential actions across Member States and thus strengthen overall confidence in the measures".[20]

Common definitions and a common taxonomy are needed to harmonise statistical reporting, with a view to ensuring comparability and improving policy analysis. Given persistent differences in local conditions, statistical harmonisation in my view should not go as far as to prevent national authorities from gold-plating reporting requirement. A more granular set of indicators might sometimes be needed to inform national policy decisions in a satisfactory way, though efforts should certainly be made to establish a fully harmonised core set.

Should any common taxonomy only be designed for data reporting, or should it also shape the legal framework for BBMs? Not just the calibration, but the very definition of LTV and DSTI limits differ across Member States. To simplify compliance, common

17 Recommendation of the European Systemic Risk Board of 4 April 2013 (ESRB/2013/1) (OJ C 170, 15.6.2013, p. 1).

18 Recommendation of the European Systemic Risk Board of 21 March 2019 amending Recommendation ESRB/2016/14 on closing real estate data gaps (ESRB/2019/3) (OJ C 271, 13.8.2019, p. 1).

19 European Commission, *Targeted consultation on improving the EU's macroprudential framework for the banking sector*, p. 10. According to the ESRB, "in some Member States, either legally binding BBMs are missing completely (Greece, Poland) or the set of available instruments is not sufficient to ensure that sources of systemic risk can be mitigated effectively any time in the future (Germany, Finland, Hungary, Liechtenstein, Netherlands, and Norway)" (ESRB, Review of the EU Macroprudential Framework for the Banking Sector - March 2022, Response to the call for advice, p. 13).

20 ESRB, Review of the EU Macroprudential Framework for the Banking Sector - March 2022, Response to the call for advice, p. 15.

definitions of the numerator and of the denominator of each ratio would surely be helpful.[21] EU legislation is needed if one wants to get there.[22]

The choice, however, is not entirely straightforward. On the one hand, greater homogeneity in the legal design of measures would reinforce integration by facilitating cross-border lending, and by making reciprocation easier. As things stand now, intermediaries may be subject to different types of BBMs, depending on the Member State(s) where they operate, which significantly complicates cross-border business. On the other hand, local real estate market conditions and regulations do differ, which would call for some country-level flexibility. In a relatively new field, it could also be argued that experimentation with new regulatory ideas, within practical limits, should not be ruled out.

An optimal regulatory choice, then, would need to balance different concerns and proceed step by step, perhaps by standardising at the outset the definitions of the more common measures, but (at least temporarily) allowing for some latitude in tailoring national measures to specific needs. Common guidance, as provided for in the case of capital-based measures, would be helpful. Doing nothing now would be a missed opportunity; on the other hand, full convergence might be better regarded as a longer-term aim.

A further step would be to set common rules, quantitative limits and procedures, like the ones that exist for capital-based measures. This might be difficult, and possibly unnecessary, right now. What is needed is that the authorities keep an eye on concrete developments, to ensure that harmful spillovers, fragmentation or 'ring-fencing by other means' do not emerge;[23] and take action if they do.

One last comment: wherever the legislative process ends up, along the scale from purely statistical to full legal harmonisation, the rules on BBMs should be as cross-cutting and 'activity-based' as possible, i.e. applicable to all lending contracts, whatever category the lending institution belongs to. This is necessary to avoid regulatory arbitrage between the banking and non-banking sectors.[24]

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21 As the ESRB highlighted "for example, six countries (Denmark, France, Ireland, Malta, Netherlands, Norway and Sweden) use gross income to define income-related measures, while other Member States use income in net terms. Three countries (Austria, Finland and Slovenia) use a broad definition of collateral value for the purpose of the LTV limits, while in other countries this is restricted to real estate." (ESRB, Review of the EU Macroprudential Framework for the Banking Sector - March 2022, Response to the call for advice, p. 13). Banca d'Italia used gross income to define income-related measures when it issued its rules on BBMs last February.

22 Under Article 513 of the CRR, "harmonised definitions" of BBMs "and the reporting of respective data at Union level are a prerequisite for the introduction of such instruments" (paragraph (1)(d)).

23 Hartmann, 2015.

24 In that respect, the legal acts already available are the Mortgage Credit Directive (Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010) and the Consumer Credit Directive (Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010).

These, as I said at the outset, are very provisional reflections (and, as such, they should not be taken as an official statement of the position of Banca d'Italia). I am sure that the discussions in this seminar will help clarify some of the economic and legal issues I have briefly mentioned, and provide intellectual food for further thoughts about the best path ahead.

Let me conclude by thanking the organisers, not least for having put together such a distinguished panel of speakers, and all the participants. I wish you all a very fruitful discussion.

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