BANCA D'ITALIA
EUROSISTEMA

Quaderni di Ricerca Giuridica

della Consulenza Legale

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

Conference Papers
Banca d'Italia, Rome, 23 September 2022

Collection of writings and contributions by Giuseppe Napoletano

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Foreword

Marino Perassi

From the financial crisis of 2007-2009, the awareness about the potential of macroprudential policy has grown. After the adoption of capital-based macroprudential measures, BBMs are drawing the attention as additional tools that may be very useful and quite sensitive at the same time.

This issue of the *Quaderni* collects many of the speeches held at the seminar organized by the legal services of Banca d'Italia on September 23rd 2022, on "*An EU Legal Framework for Macroprudential Supervision through Borrower-Based Measures*".

The momentum for the seminar was given by the completion of the consultations conducted by the Commission to assess "*whether other types of instruments, such as borrower-based instruments, should be added to the macroprudential tools provided for in this Regulation and in Directive 2013/36/EU…*".[1]

In a broader perspective, the contributions sketched various aspects of macroprudential measures that are based on the features of borrowers or of the loans ('BBMs'): from their potential to the challenges that they raise for policy- and law-makers. Such hints might hold valid over time and beyond the EU contingencies.

The seminar was opened by the Director General of Banca d'Italia, who highlighted the complementarity between monetary policy and macroprudential policies, e.g. to adjust the effects of the single monetary policy in the EU by using BBMs at local level on real estate markets, that are by nature geographically localized.

The institutional governance should be consequential to the economic reality: as real estate markets are by definition fragmented, "*a key responsibility for initiating and calibrating*" BBMs *"should therefore remain at the national level*"; "*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*".

As regards the use of BBMs, the Director General addressed two messages:

first, the need of flexibility in the use of BBMs. It should be possible to use each of them not only in combination with capital-based macroprudential measures but also with other BBMs: since "*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*", "*[t]he effect is stronger when LTV, DSTI and DTI caps are imposed jointly*";

1 Article 513(1)(d) of the Regulation (EU) No 575/2013-'CRR'.

second, “*rules on BBMs should be … 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*”.

The Director General eventually encouraged not to miss the opportunity to make steps forward in improving the EU framework on BBMs. A common taxonomy for a set of statistical indicators would improve policy analysis across the EU. Harmonising somehow the legal design of BBMs would “*reinforce integration by facilitating cross-border lending, and by making reciprocation easier*”.

An interesting case of combination of BBMs measures was brought to the attention by Julien Idier from Banque de France.

The French High Council for Financial Stability (HCFS) had to confront with the risk of a bubble in the residential real estate market in 2019. It chose to adopt a recommendation where a DSTI was combined with a 25-year maturity limit, to prevent circumventions of the DSTI limit. An LTV cap was discarded, since in France “*credit risk analysis is based on an analysis of borrowers’ income (DSTI) and on their repayment capacity, not on the valuation of the property*”.

The HCSF also provided for flexibility margins, so that lenders may deviate from the DSTI cap for a 20% of their quarterly loan production; which is, *inter alia*, more than a hint that those provisions hardly could impact the validity of the single contracts.

The Head of the ESRB-European Systemic Risk Board Secretariat, Francesco Mazzaferro, covered the twelve-year ESRB experience to prove that it is necessary “*the legal availability of some more immediate reaction capacity, if we want that macroprudential policy can be activated to help preserve financial stability*”.

He reminded that the ESRB has recently concluded that the *acquis communautaire* should be enriched by BBMs for residential real estate loans.

While the EU legislation should include a minimum reference to a core set of BBMs – such as LTV limits, DTI and DSTI limits, Maturity limits and Amortisation requirements –, Member States could offer a wider set of BBMs.

He also underlined the need to figure out how to enshrine EU provisions on BBMs in legal tools that would ensure that BBMs can be applied to loans provided by all types of lenders.

Aware of “*the increasing cyclical correlation of our economies*”, the Head of the ESRB Secretariat hoped that on BBMs the EU could obtain “*a minimum level of harmonisation, inspired by the principles of subsidiarity and proportionality*”.

Policy decision would remain exclusively with Member States, following the principles of “guided discretion” within the ESRB net, for a consistent application of BBMs across Member States.

Arien van’t Hof brought the view of the Commission on the pivotal role that BBMs may play in preventing systemic risk in the real estate market without inducing lenders to deleverage.

He referred on the outcome of the consultations conducted by the Commission under Article 513 CRR: they were clear to manifest a shared view on making steps towards a harmonisation as a minimum of common indexes for reporting requirements in the real estate markets.

Van’t Hof did not hide the difficulties that the Commission faced with reference to the balancing of powers at EU and at national level. Nonetheless, he highlighted the will of the Commission to continue in its actions aimed at setting a minimum harmonisation of some core BBMs, which would certainly help Members States to complete their legal framework where necessary and lessen fragmentation of markets.

Alessio de Vincenzo and Giuseppe Napoletano described the main features of the new Italian rules on BBMs: a core of basic provision inserted in the Consolidated Banking Law (CBL) guarantees the respect of the rule of law. On that basis, the rules adopted by Banca d’Italia in 2022 are very flexible, as BBMs limits can be applied: to loans to households or firms; with or without exemption thresholds; in the same way to all loans or differentiating based on borrowers’ and loans’ characteristics; at national level or for specific geographical areas; alone or in combination; if deemed as necessary, also simultaneously with other types of macroprudential instruments.

However, BBMs’ activation shall follow the identification of systemic risks according to the indicators identified by the ESRB and other indicators or models, including stress tests.

A final reflection is dedicated to the troubled case-law on the application of a pre-existing provision of the CBL on LTV for real estate loans; that history might help in figuring out how important is to shape properly the rules on BBMs.

Anat Keller from the King’s College of London closed the seminar with her speech on the legal challenges of BBMs.

She premised that BBMs may give immediate evidence of distributional effects (e.g., making more difficult for young couples to buy their first house) while their benefits for the whole economy can be appreciated only in the medium term due to the preventative nature of macroprudential policy; which might create a special pressure on policy makers.

She also underlined how credibility of the technical authorities that are mandated to operate BBMs might be challenged by recent tendencies to expand the use of BBMs to tackle financial risks caused by climate change.

The special sensitiveness of decisions on BBMs made her suggest to provide for a diversity of channels of accountability arrangements.

She moved from the observation that in the macroprudential field it might be difficult to fix a clear benchmark "*against which the success of the macroprudential authority in achieving its mandate can be judged*".

If so, the classic *ex-post* accountability mechanisms could be supplemented by *ex-ante* monitoring tools, ranging from robust decision-making processes – with a transparent cost-benefit analysis – to prior consultation, to seek where possible feedback from external stakeholders.

The *Quaderni* treated the macro prudential legal topics in the issue n. 76 – *Legal aspects of macroprudential policy in the United States and in the European Union* (*Profili giuridici della politica macroprudenziale negli Stati Uniti e nell'Unione Europea*), by avv. Giuseppe Napoletano.

Heartfelt thanks to Giuseppe for having organised the seminar in Banca d'Italia on this matter and for the precious work of coordinating and collecting the contributions published hereafter.

Welcome address of the Senior Deputy Governor of the Bank of Italy

Luigi Federico Signorini

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, 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.

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.

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.

[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 does suggest is 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,

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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).

such as banks, borrowers or countries, even 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

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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).

has defined and published the procedure that it follows when reviewing the national measures.[16]

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 requirements. A more granular set of indicators might sometimes be

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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).

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.

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 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.

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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.

This is necessary to avoid regulatory arbitrage between the banking and non-banking sectors.[24]

* * *

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.

[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).

Borrower-based measures: The french experience

Julien Idier[*]

In France, the macroprudential authority is the High Council for Financial Stability (HCSF).[1] The HCSF has the ability to deploy borrower measures (BBM), among other macroprudential tools. The Banque de France is responsible for proposing the adoption BBMs to the High Council. As indicated by the French Monetary and Financial Code, BBMs should be activated in order to prevent the emergence of excessive upward movements in asset prices or excessive indebtedness of economic agents. They apply to entities having received the authorization to grant loans to economic agents located on French territory or intended for the financing of assets located on French territory. Thus, all the provisions governing the implementation of BBMs in France come from national legislation alone, since no European provision is provided in this regard.

The following sections briefly describe how the French authorities initiated, designed and ultimately implemented borrower-based measures (BBM). It is written on the basis of a presentation made in September 2022 during the Banca d'Italia workshop on the challenges to implement an EU framework for borrower-based measures.

Diagnosis and public consultation on real estate risks as a starting point

In the fall of 2019, the HCSF published its diagnosis on residential real estate on its website. He noted that credit-granting practices were becoming significantly looser with, in particular, an increase in practices that are deemed the most risky: extension of maturities, increase in debt service to income ratios (DSTI), increase in the share of loans with a DSTI greater than 35% or down-payment less than 5%.

The publication of the HCSF's diagnosis was a warning to all market participants, in particular:

- For households, to alert them on the risks related to their ability to repay. A striking feature is that repayment capacity has deteriorated

[*] Banque de France. Head of Macroprudential Policy Division – Financial Stability Directorate. The analysis, opinions and findings of this article do not necessarily reflect official positions of Banque de France.

[1] It is composed of eight members and chaired by the Minister of Finance. The other seven members are the Governor of the Banque de France, the Chairman of the Financial Markets Authority, the Chairman of the Accounting Standards Authority, the Vice-Chairman of the Prudential and Resolution Authority (called ACPR) and three academics.

over the past decade while interest rates trended lower; the decrease of interest rates was actually offset by an increase in debt.

- For banks, credit risk to households could increase given the higher share of income devoted to loan repayment, which affects the ability of households to withstand economic shocks.

These two risks are all the more crucial as they could weaken the real estate financing model in France, which is based on three pillars ensuring its robustness:

- First, loans are contracted at fixed rates over the total duration of the loan: the interest rate risk is managed by the banks rather than by the households. Banks are considered to be better equipped than households to manage interest rate risks both in terms of financial instruments and in terms of financial strategies. However, if households benefit from fixed interest rates over the full term of the loans, it is important that the maturities do not lengthen too much: the higher the maturity the stronger the risk transfer (and cost of interest risk hedging) to banks. In addition, this implies that the pricing of loans takes into account the cost of hedging the interest rate risk borne by the banks.

- Second, the banks' capital hedging model is efficient because it relies on low default rates and dual recourse. Indeed, the banks make their own credit risk analysis which is supplemented by the credit risk analysis of a guarantor called "*organisme de caution*". This guarantor is a specialized insurance scheme to which banks and households contribute to cover potential losses incurred on home loans. The risk pooling is very efficient given the good quality of the loans accepted and makes this collective guarantee cost-efficient. In practice, these guarantors are specialized banks, supervised by the ACPR, to which regulatory banking ratios apply and are submitted to stress-tests.

- Third, financial stability is relatively immune, in France, to changes in house prices as credit risk analysis is based on an analysis of borrowers' income (DSTI) and on their repayment capacity, not on the valuation of the property. Therefore, it relies on a conservative approach, based on employment status / regularity of income with a reasonable DSTI. Typically, the leverage effect associated with the valuation of the house as collateral is not a mechanism at work in France (unlike the Anglo-Saxon model) since there is no pledge.

By publishing its own diagnosis, the HCSF echoed the similar findings of the IMF made during the last FSAP of 2018-2019 and of the warning of the ESRB to France on real estate risks. It was also an opportunity to launch a public consultation on the basis of this diagnosis to initiate a dialogue with all the stakeholders: banks, financial intermediaries, brokers, consumer protection associations, family associations. The objective was to ensure the acceptability of possible BBMs and to ensure the future effectiveness of these measures. It was also important to explain the purpose of the HCSF within its mandate. In particular, to ensure that the measure envisaged indeed pursues an objective of financial stability while limiting its unintended social impact, such as the exclusion of certain types of borrowers from home ownership.

Starting with a recommendation provides enough flexibility to test and adjust the measures

Given the risks identified by the HCSF, choosing to introduce a DSTI was fully justified. First, considering a DSTI ratio of 33% was a common practice before credit conditions started to loosen. Second, there was no sign of real estate bubble and the real-estate property (and its value) is usually not pledged in France. Therefore, a loan-to-value (LTV) cap was not justified by market characteristics. Finally, to guarantee the absence of circumvention of the DSTI limit by extending loan maturities, the DSTI limit was associated with a 25-year maturity limit.

To ensure that the introduction of BBMs reasonably address financial stability risks without having too strong an impact on first-time buyers (FTB), it was decided to introduce a flexibility margin of 15% of quarterly loan production. Thus 15% of production may not comply with these DSTI and maturity limits and is especially targeted to FTB. These flexibility margins were also important to partially accommodate complex borrowers such as borrowers with complex incomes for which the DSTI calculation may not be possible.

For this first introduction of BBMs in 2019, the HCSF decided to opt for a recommendation. This form of decision was flexible enough to "test" the BBM package and to adjust the measure if necessary in order to strike the right balance between the objective of financial stability and the potential side effects of the measure. This flexibility and phased-in approach was essential to:

- Confirm the potential impact of the measure: indeed, one difficulty was that the information we had on credit conditions was already good but not fully aligned with the criteria that the HCSF decided to use as BBM. Therefore, there was some inherent uncertainty about the final impact of the measure;
- Ensure that the definitions used, for example regarding income, debt service, first-time buyers, main residence, were aligned with existing legal texts and applied consistently between banks;
- Finally, give banks some time to adjust their information system so that the HCSF recommendation was fully taken into account in their practices.

Defining borrower metrics remains a challenge: The devil is in the details

Even if the ESRB recommendation 2016/14 on reducing data gaps in real estate provides a starting point for the definitions of the macroprudential instruments, these remain broad, so that it is necessary to adapt to country specificities and to the heterogeneity of borrowers.

To take just one example: in the case of the DSTI, the HCSF had to provide guidelines on how income is defined. Should it be net or gross? After taxes but which taxes to include? What criteria make an income secure and stable enough for it to be included in the DSTI calculation? How to include financial income? How to consider future rents in the case of a buy-to-let investment (deducting borrowing costs in the numerator of the DSTI or adding it as income in the denominator)? Nothing was clearly defined before the HCSF decided to establish BBM. For this, it was essential to have very close cooperation between staff in charge of designing macroprudential policy and the legal services of the Banque de France, the Ministry of Finance and the bank supervisor – ACPR.

Behind the setting of these definitions, there is the key issue of ensuring a level playing field between banks. The definitions help to anchor common practices in all banks, especially when competition is strong, which is the case in France. We also observed that beyond maintaining a level playing field, it actually improved it: even if the DSTI was "common practice" between banks, its calculation was highly heterogeneous between banks before the HCSF introduced clear definitions.

From a recommendation to a legally binding decision

After a year of implementation of the recommendation, i.e. at the end of 2020, the HCSF decided to resume consultations with professionals and associations to adjust the recommendation. These adjustments were also the result of on-site inspections of banks by the ACPR. Thus, the HCSF proposed an updated version in order to:

- systematically integrate borrower insurance costs into debt service calculation. The practice was not harmonized between the banks and led to non-comparable DSTI calculations. This was partly accommodated by raising the DSTI ceiling from 33% to 35%;
- take better account of first-time buyers and primary residences by increasing the flexibility margin from 15% to 20% for the benefit of these two categories of borrowers;
- for the special cases of new housing and major renovation work, to add a "grace period" of a maximum of 2 years to the maturity cap of 25 years taking into account the construction/renovation delays.

These adjustments were published through a revised recommendation in January 2021, while the press release also already signaled that the measure would become legally binding in the coming months. The objective of this gradual introduction was to give banks time to adjust their practices and comply with the measure as soon as it would become binding. As of September 2021, all banks met the HCSF criteria, showing that adopting a legally binding decision, enforced on 1st January 2022, ensured that practices did not loosen further in the future.

Finally, to ensure that the measure is properly applied and that the questions raised about the design of the DSTI remain accessible, a frequently asked questions (FAQ) has also been published on the HCSF website to guide banks and borrowers.

Conclusions: Towards a european BBMs framework?

Defining and implementing borrower measures remains a challenge for macroprudential authorities. However, many countries have moved in this direction in the EU and show that this is a leading action for macroprudential authorities that had solved these difficulties.

It must be recognized that it is difficult to compare BBMs between countries given national specificities: housing loan contracts differ; the definition of income, taxes, debt may differ; the legal forms taken by BBMs differ (recommendation, legally binding decision); the power to make such decisions may not lie with macroprudential authorities; the choice of tools may be constrained (DSTI for example may not be part of all national toolboxes). All this shows the need for flexibility.

However, finding the right balance between flexibility and harmonization should not be neglected in order to achieve a dedicated legal framework at EU level. Insufficient flexibility could simply kill any incentive to apply BBMs whose design does not match the needs of the country. On the contrary, too much flexibility and discretion can also constitute a risk for the financial integration of the EU and its financial stability. As indicated by the HCSF during the EU consultation on the review of the macroprudential framework, CRR or CRD should consider BBMs in a flexible way at least to ensure that the toolkit is available in each EU country. Then, experience shows that the design of the tool, its calibration, the work on the definitions, can only be carried out at the country level for BBMs to be effectively implemented.

Macroprudential policy and its tools: Why embedding borrower-based measures in EU law is needed now

Francesco Mazzaferro[*]

Banca d'Italia is hosting today the first Europe-wide legal conference discussing whether and how Borrower Based Measures (BBMs) should be included in the EU legal framework, in order to become part of the common macroprudential policy toolkit. This occurs only a few months after the recent publication of the ESRB Concept Note, entitled "Review of the EU Macroprudential Framework for the Banking Sector", in which the European Systemic Risk Board (ESRB) proposed that step. And it gives me a nice opportunity also for presenting some personal, critical views about what still needs to be accomplished to bring macroprudential policy in Europe to the state it deserves.

At this stage, let me warmly recognise Banca d'Italia for holding this event today. A feeling of gratitude is due to Luigi Federico Signorini, the Senior Deputy Governor, to Marino Perassi, the Bank's General Counsel, and Giuseppe Napoletano, the one who has inspired the discussion today, but had also established the legal function at the ESRB Secretariat of the European Systemic Risk Board (ESRB) ten years ago. Of course, I would also like to manifest my very warm sense of recognition and respect to the many other Italian colleagues who have gathered here today, for their constant support to the ESRB work.

Before entering the topic of BBMs, I would like to take a multi-year perspective. I took this job in March 2010, almost one year ahead of the formal inception of the institution. The legislation was still being discussed. At a certain stage, we asked ourselves how to implement the basic mandate of the ESRB regulation, which was finalised on 24 November 2010: "to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth".

At that time, we thought the ESRB's added value, compared to other public and private bodies in charge of monitoring risks, would be to identify long-term vulnerabilities, and mainly those which were new and unaddressed. Implicitly, we

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were convinced that progress in the correction of those market failures leading to the Great Financial Crisis of 2007-2008 had already been satisfactory. The ESRB was there mainly to counterbalance the ‘short-termism’ of markets, and certainly not to directly impact on their functioning. The basic assumption was threefold: first, systemic risk was building up very gradually; second, it was endogenous to the financial sector; third, it would be possible to avoid its materialisation by setting up incentives correctly.

The scarcity of macroprudential tools assigned by EU legislation to national authorities and the lack of hard powers attributed to the ESRB itself seemed, at least to many of us, to be in line with this interpretation of the legislation. I remember, we felt like those sentries who are scrutinising day and night the line of the horizon at the scrutiny of worrisome developments. And – going back of my youth readings – I thought at Dino Buzzati’s *The Tartar Steppe*: perhaps, like commander Giovanni Drogo, I would spend several years in a long-term oriented institution, being entrusted with the daunting task of guarding the borders from new enemies, but possibly never encountering them. As all know, Buzzati’s novel ends with the Drogo having passed every day of his entire life to defend homeland against a remote enemy which never showed up.

Only a few weeks after the inception, that concern proved wrong: the ESRB was immediately confronted with the propagation of the sovereign-bank nexus, due to the spreading of sovereign crises in the European Union. And the immediate new question was: do we have macroprudential tools to fight propagation and reduce the damage? In fact, we were unarmed. The crisis had intervened too soon, and no build-up of macroprudential buffers had been possible, thus no release was within the reach of macroprudential authorities. Moreover, in several Member States macroprudential authorities did not exist yet, or their mandate was unclear. Certainly, the regular meetings of all ESRB members permitted our members to exchange information and views in a frank and confidential manner. We provided a European view of the crisis, avoiding the trap of considering it as the mere sum of idiosyncratic national incidents. The ESRB also contributed to strengthening resilience of the financial sector, by providing to the European Banking Authority the adverse scenarios for the stress tests in 2011 and 2014. Between those two exercises, interestingly, stress tests were suspended, due to excessive uncertainty on future events. All in all, in the first five years of existence of the ESRB our operational capacity to mitigate risk was feeble, because macroprudential instruments had not been loaded.

The space for use of macroprudential tools reopened in the second half of the decade, when pressure from the crisis started to alleviate selectively across the EU. To be recalled, the ESRB activated itself quite soon and issued warnings in September 2016 on medium-term vulnerabilities in the residential real estate sector, addressing them to eight Member States: Austria, Belgium, Denmark, Finland, Luxembourg, the Netherlands, Sweden and the United Kingdom. Three years later, in June 2019, the ESRB issued warnings to five new constituencies (the Czech Republic, Germany, France, Iceland and Norway) and issued recommendations to six of the previously warned countries (Belgium, Denmark, Finland, Luxembourg, the Netherlands, and Sweden).

Unsustainable dynamics in the real estate markets were potentially a symptom of a broader accumulation of risks. What we observed in those years was that, more and more, the newly created macroprudential authorities tried to address the build-up of vulnerabilities by making use of BBMs. This was a new field, and we entered it with great caution, also because those instruments were not provided for in EU legislation and, in particular, were not among those for which the EU legislation assigned tasks to the ESRB by the Capital Requirements Directive (CRD) or through Article 458 of the Capital Requirements Regulation. The latter were: (i) the level of own funds; (ii) the requirements for large exposures; (iii) the public disclosure requirements; (iv) the level of the capital conservation buffer; (v) liquidity requirements; (vi) risk weights for targeting vulnerabilities related to the residential property and commercial immovable property sector; or (vii) intra financial sector exposures.

By making an innovative macroprudential use of BBMs, national authorities pursued three aims. They wanted to contain the indebtedness of households. They tried to ensure that there would be sufficient collateral should residential real estate prices drop from overvalued levels. They solicited banks to set aside sufficient resources (in terms of credit provisioning and capital) in case of an abrupt change of market conditions. Often, those finalities were combined. In June 2014, for instance, the Bank of England's Financial Policy Committee (i.e. the macroprudential authority of the United Kingdom) introduced 'affordability tests', stressing the conditions for lenders when the portion of risky mortgages (measured according to the prospective borrowers' ability to repay) had reached certain thresholds. In this way, BBMs were complementary to capital-based measures.

How was the main macroprudential tool, the Countercyclical Capital Buffer (CCyB), used by macroprudential authorities in the second half of the 2010s? The CCyB entered into force in July 2013, together with the latest version of the CRD. The ESRB issued in June 2014 a recommendation on guidance for setting countercyclical buffer rates. In the following years, following that recommendation, the activation of CCyB started in three corners of the European Union: the United Kingdom and Ireland, the Scandinavian countries, and some countries in Central and Eastern Europe. Let us review a few examples of what happened, until the Covid shock in March 2020 when all of these countries decided to decrease the CCyB either partially or to 0%:

- *Sweden* set the CCyB at 1% in <u>September 2014</u> (for full implementation one year later) and increased it several times up to the level of 2.5%.

- The *Czech Republic* activated the CCyB at 0.5% in <u>December 2015</u> (for full implementation in January 2017) and increased it several times up to the level of 2%.

- The *UK* activated the CCyB at 0.5% in <u>March 2016</u> (for full implementation one year later). When it left the ESRB at the beginning of 2020 due to Brexit, the CCyB was set at 2%.

- *Slovakia* activated the CCyB at 0.5% in July 2016 (for full implementation one year later) and increased it several times up to the level of 2%.
- *Lithuania* activated the CCyB at 0.5% in December 2017 (for full implementation one year later) and increased it later on up to the level of 1%.
- *Denmark* activated the CCyB at 0.5% in March 2018 (for full implementation one year later) and increased it up to the level of 2%.
- *Ireland* activated the CCyB at 1% in July 2018 and kept it unvaried until April 2020.

Significantly, in none of the above countries the possibility to build-up buffers at a higher pace than the 12-month period between announcement and full implementation was made use of. In fact, in a few cases the announced CCyB was not even fully phased in, when these countries decided to lower it again following the Covid shock. In other words, also for 'activist' countries, the transition was gradual. Let me observe that, if we think of current conditions at the time of this conference, any decision affecting credit conditions only in 12 months would be subject to many question marks. Let us think of the geopolitical discussions about the risks of the Ukraine war turning in the worst case into a global nuclear conflict, the threat of looming energy scarcity and sky-rocketing energy prices and the issue of time and modalities of monetary policy normalisation.

A few other EU Member States activated macro-prudential tools in the second half of 2010s, but in an even more prudent and gradual mode. *France*, for instance, announced the activation of the CCyB at 0.25% in July 2018 (for full implementation one year later) and increased up to the level of 0.5% in April 2019. In *Germany* it was activated at 0.25% in June 2019 (for full implementation one year later) and kept unchanged until March 2020 when it was completely released. *Luxembourg* activated the CCyB at 0.25% end 2018 for implementation at the beginning of 2020; it increased it later to 0.5% and kept it unchanged over the Covid pandemic.

For their own admission, in many other EU countries macroprudential authorities recognised some concerning credit dynamics, but wanted to wait before taking firm action, also to leave room to the economy to recover to pre-crisis levels. The assumption was: macroprudential policy is for the start of the next decade, when we will have come back to normal after the Great Financial Crisis and the Sovereign Debt Crisis. To be fair, several macroprudential authorities had also established systemic risk buffers to increase resilience against non-cyclical vulnerabilities. However, when the Covid pandemic hit us in March 2020, only a minority of the 27 Member States had macroprudential space to release a significant amount of regulatory capital. The release of all regulatory buffers in the EU after the shock amounted to EUR 140 bn, but only 20 of them were associated with macroprudential buffers. For a second time, we were unarmed. The task of preserving financial stability in front of a sudden exogenous shock of the highest proportion was mainly left to monetary and fiscal policies.

When, only two years later, the European Union was surprised by another violent exogenous shock – with Putin's decision to reignite war against Ukraine in name of a neo-imperial design also threatening the full of Europe – the old discussions about the 'long-term' orientation of macroprudential policy came back again to my mind. I felt once again that – like in the early 2010s and in 2020, macroprudential policy was providing an insufficient policy response.

Looking at the many years with sufficient distance, a lot of progress has been certainly achieved in macroprudential policy making since the ESRB's inception. Still, in a world increasingly subject to frequent and serious exogenous events, macroprudential policy comes to its limits if it is not proactive. Waiting for the perfect conditions before moving is not any more an available strategy. This is most probably true also for the future. In fact, we are now confronted with a multi-layer set of crises (energy, climate, geopolitics, cyber, crypto), which have the potential to hit the financial sector and reverberate across the economy. They require the legal availability of some more immediate reaction capacity, if we want that macroprudential policy can be activated to help preserve financial stability.

And this brings me back to borrower-based measures.

Macroprudential authorities have paid particular attention to developments in real estate, recognising that few financial stability crises are completely disconnected from them. This is true for different reasons. For households, mortgages are the most important financial obligation over the life cycle; depending upon market features and conditions, they may expose a large part of population to the risk of overindebtedness and thereby compress their living standards. For banks, financing house purchase of customers is the largest exposure; an adverse development would confront credit institutions with new waves of non-performing-loans and potentially set the viability of the banking sector at risk. Besides, commercial real estate is a different, but related, market segment which is particularly volatile and exposed to interest rate conditions. Finally, expectations about real estate price dynamics have sometimes proven to be self-fulfilling, defying gravity and the overall conditions of the economy. This raises the risk of an abrupt price correction with its deflationary impact.

For this reason, BBMs are of the utmost importance, as they ensure minimum credit standards for new housing loans and, therefore, lead to higher resilience of households as well as credit providers. Used pro-actively, they can also offer more tailor-made tools – compared to capital buffers – to address unsustainable credit-driven cycles. BBMs include:

- Loan-to-value (LTV) limits;
- Debt-to-income (DTI) and debt-service-to-income (DSTI) limits;
- Maturity limits;
- Amortisation requirements.

BBMs belong today to the exclusive domain of national law: in fact, they are neither mentioned in the ESRB legislation nor in the CRD nor in the Mortgage Credit Directive (MCD). In most EU Member States authorities have the possibility to activate (at least some of) them as legally binding constraints, when needed. In others, however, national legal frameworks have drawbacks.

- In Greece and Poland, a national framework for residential real estate is missing completely.
- In other four EU countries, the set of BBMs is insufficient (Finland, Germany, Hungary, and Netherlands).
- In other countries, governance issues may also lead to inaction bias or the legislation may be less conducive to timely use of the measures, which is important for their effectivity.

Therefore, the ESRB has recently reflected about the perimeter of macroprudential policy in Europe and come to the conclusion that EU macroprudential tools should be enriched by BBMs for residential real estate loans. Including them in the acquis communautaire would enable all EU Member States to mitigate sources of systemic risk more effectively at the national level.

From a financial stability angle, providing all Member States with a basic set of common macroprudential tools in the realm of real estate is, in particular, valuable when cycles in EU countries are synchronised to a significant extent (for instance, due to the impact of exogenous shocks). In policy terms, BBMs must be activated in a preventive way, possibly in combination with capital measures or in a cocktail of BBMs at the same time. They may need to be calibrated differently depending on borrower or loan characteristics. Authorities should be also free to define exemptions from them. In order to prevent circumvention, and to facilitate the further integration of the Single Market, the EU legislation should also enhance reciprocation of measures, and the monitoring of risks to financial stability across the EU.

While the EU legislation should include a minimum reference to the above-mentioned tools, Member States should feel encouraged to offer a wider set of instruments to the respective authorities or to offer *full flexibility* to use any macroprudential instruments related to the loan or borrower characteristics of residential real estate loans. Those countries which already allow for the activation of the tools with flexibility should be considered compliant with the requirement. Other countries should adapt and integrate their legislation.

I have referred above to risks of inaction biases in some jurisdictions. Of course, political considerations can be a factor that prevents or delays the appropriate use of BBMs, given their obvious distributional effects. However, the EU legislation might help address this issue:

- Member States should be strongly advised to entrust the designated or macroprudential authorities with an active role in activating, calibrating and releasing BBMs. This is simply because it is essential to involve authorities with sufficient experience in addressing risks to financial stability.

- An essential pillar of an effective governance framework for BBMs would also be transparency and accountability of the relevant responsible authorities. In this respect, *all institutions* involved in decision-making on BBMs should regularly assess sources of systemic risk stemming from the residential real estate markets and the need to use BBMs. The main conclusions of such assessment should be publicly available.

I am aware that setting a general principle (inclusion of BBMs in the EU macroprudential legal framework) also requires addressing a few crucial issues. I would like to briefly refer to three of them: first, how this insertion should occur; second, what relationship should exist between centralisation and decentralisation; and third, whether BBMs should be used beyond the residential real estate sector.

On the first point: there is no need to include a direct reference to BBMs in the ESRB regulation. However, they should be referred to both in the CRD, as well as in the MCD. On the one hand, the inclusion in the CRD would ensure that BBMs are applied at the same level as capital-based measures. On the other hand, the reference in the MCD would ensure that BBMs can be applied to loans provided by all types of lenders, including branches of EU banks, insurance companies, investment funds and pension funds.

Concerning centralisation vs. decentralisation, it goes without saying that the diversity of residential real estate markets, the variety of business models and commercial traditions and the diverse legal constraints make it necessary to conceive BBMs as instruments which must be activated, calibrated and released at national (or possibly, even sub-national) level only.

This means that a general framework would be set at the European level, but the implementation would be left at national level, following the principles of "*guided discretion*": to foster more consistency in the use of BBMs, the ESRB could provide guidance to national authorities on the sound and consistent application of BBMs across Member States. Notwithstanding this, any policy decision would remain exclusively with those Member States.

- When it comes to the design of BBMs, the EU legal framework should consider only a minimum level of harmonisation, inspired by the principles of subsidiarity and proportionality.
- EU legislation should describe the general principles and concepts of the BBMs but leave further details of the definitions to Member States. This would allow to address national specificities. It would also ensure that Member States which have already activated BBMs can continue to use their current definitions.

- When describing the general principles and concepts, the EU legal framework should make a reference to the definitions in the ESRB Recommendation on closing real estate data gaps of 2016 (ESRB/2016/14), amended in 2019 (ESRB/2019/3). This is because the recommendation contains definitions that take into account international initiatives in the area of data collection and harmonisation.
- There is a broad consensus that, in line with what was mentioned above, decisions of BBMs should not be subject to the topping up powers which the ECB has been provided with Article 5 of the SSM Regulation.

Turning finally to the field of application of BBMs, EU legislation should focus, as a priority, on BBMs for *residential real estate loans* provided by banks. Nevertheless, Member states should have the possibility to make BBMs applicable also to other consumer loans and loans provided to legal persons, thereby avoiding circumvention of the measures via so called top-up loans. Also, applicability to loans provided to legal persons would impede eluding the BBMs by, for example, creating a small company to purchase buy-to-let property. This would, for instance, prevent the transfer of risks from the household to the investor sector, ensure a level playing field for households and other players on the housing market and mitigate additional fuelling of the residential real estate vulnerabilities by investment activity.

Going forward, EU legislation should aim for *activity-based* regulation in general. Such arrangements would prevent regulatory arbitrage and competition between regulated and non-regulated market participants. To this end, the principle of '*same activities, entity-specific risks, consistent rules*' could provide guidance for reforming the EU macroprudential framework.

Let me conclude. The purpose of my – also personal – reflections today has been to analyse how macroprudential policy should be beefed up at a stage of unprecedented uncertainty. We have learnt from several macroprudential authorities of the European Union that Borrower Based Measures (BBMs) offer room to mitigate proactively vulnerabilities of banks, households, and markets. They can be used both in coordination with capital rules or separately. In several cases, they have been the core tool to reduce the progression of unsustainable trends in a nimble way, also due to the slow motion which has characterized, in some cases, the implementation of traditional macroprudential tools in the European Union.

At the same time, BBMs are available in different ways across the European Union. Discrepancies reflect the past, but not the increasing cyclical correlation of our economies. Therefore, embedding now BBMs in EU law, according to principles of "*guided discretion*" and decentralised implementation, would be a step ahead towards securing better prospects for financial stability.

Borrower based measures in the EU: The European Commission's consultation on improving the EU macroprudential framework for the banking sector

*Arien van't Hof**

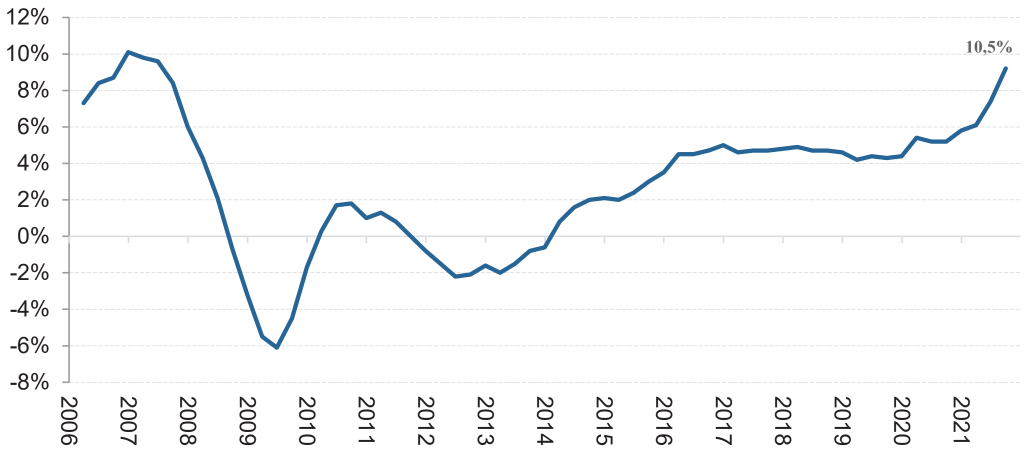
Summary: *1. Introduction – 2. Capital-based and borrower-based measures to address systemic risks in the real estate sector – 3. The review of the EU macroprudential framework for the banking sector and BBMs – 4. Considerations regarding adding BBMs to the EU macroprudential toolkit – 5. Concluding remarks*

1. Introduction

In recent years, nominal house prices and mortgage lending have risen strongly in most EU Member States, with an average y-o-y house price increase of 10.5% at the end 2021, the highest since the global financial crisis (figure 1).

Figure 1

Residential real estate price growth in the EU



Source: Eurostat.

* Dr. Arien van't Hof, LLM, MSc was policy officer at the European Commission, DG FISMA, seconded from the Financial Stability division of De Nederlandsche Bank at the time of contributing to the conference.

However, annual growth rates have varied significantly across Member States. These strong price increases are often accompanied by signs of overvaluation. Amidst concerns about rising vulnerabilities, many Member States have taken specific macroprudential measures for residential real estate risks in the past decade, considering lessons learned from past crises, notably the global financial crisis. Real estate markets namely have played a major role in past financial crises, particularly where unsustainable housing and credit booms were followed by significant corrections, triggering banking crises.

2. *Capital-based and borrower-based measures to address systemic risks in the real estate sector*

In the EU, the most widely used macroprudential tools to address systemic risks in the real estate sector are capital-based and borrower-based instruments. These tools are often complementary and address different aspects of the risks related to real estate markets and mortgage lending. The European Systemic Risk Board (ESRB) has played an important role in fostering policy actions with its warnings and recommendations concerning residential real estate.

The EU regulatory framework, consisting of the Capital Requirements Regulation and Directive (CRR and CRD),[1] provides authorities with for macroprudential capital-based tools for banks, which are the dominant providers of mortgage credit in the Union. This toolkit consists of risk weight adjustments, as well as capital buffers to enhance banks' ability to absorb shocks without deleveraging.[2] Banks could deleverage by reducing their lending to the economy or by de-risking through switching exposures to assets with lower risk weights. If risk weights – which are used to determine the overall riskiness of banks' asset portfolios – underestimate risks from a macroprudential perspective, they can be increased, implying higher capital requirements. Tighter capital requirements such as higher risks weights and sectoral buffers particularly increase the resilience of banks to the consequences of house price shocks. Some buffers can be released after the risk they address has materialized or is reduced, such as the Countercyclical Capital Buffer (CCyB) and the (sectoral) Systemic Risk Buffer (SyRB). In the past years, authorities opted for different solutions to increase banks' resilience for systemic real estate risks and did not consider each instrument to be equally adequate.[3] The Commission has scrutinized and

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1 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012; Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms.

2 Articles 124, 164 and 458 CRR provide authorities with possibilities to adjust risk-weights or risk-weight parameters, whereas Articles 133 and 136 CRD allow authorities to set a (sectoral) systemic risk buffer and a countercyclical capital buffer, respectively.

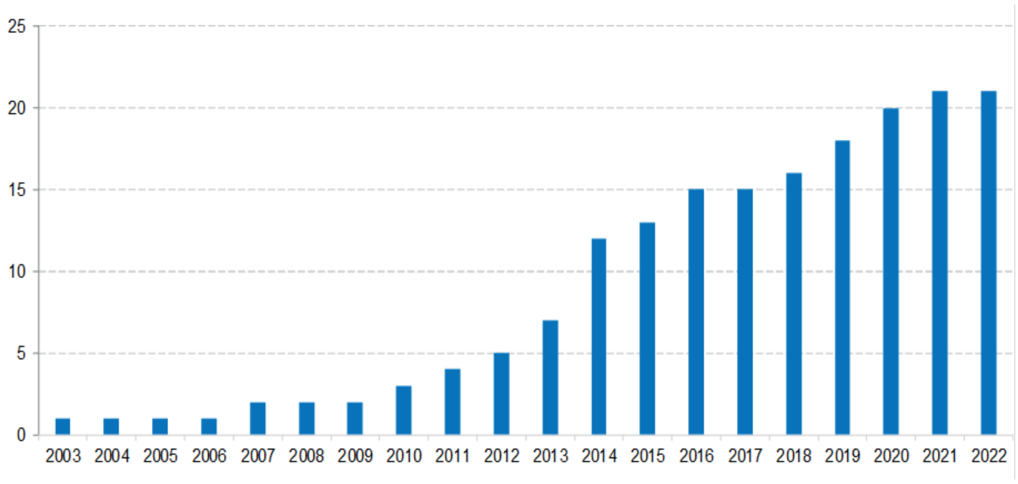
3 On its website, the European Systemic Risk Board (ESRB) maintains an overview of macroprudential measures taken by national authorities.

approved various of these national measures, based on the procedures applicable for the national flexibility measures (Art. 458 CRR) and sectoral systemic risk buffers (Art. 133 CRD).

Borrower-based measures (BBMs), such as loan-to-value (LTV), debt-to-income (DTI), loan-to-income (LTI), and debt-service-to-income (DSTI) limits, by contrast, are based on national legislation and can apply beyond banks. With the increasing vulnerabilities, the number of Member States that have activated these measures has also grown (figure 2).

Figure 2

Member states that have activated borrower-based measures for RRE



Source: ESRB, national authorities.

Although these borrower-based measures are widely used, they differ across Member States (see Table 1), notably regarding:

- the type of available measures, in particular as regards income-related BBMs;
- the purpose (macroprudential; microprudential; consumer protection; or a combination of the former);
- the legal basis (binding or non-binding);
- the authority in charge of the implementation (government; central bank; supervisor; or a national financial stability committee);
- the scope (ranging from domestic banks only to all domestic and foreign credit providers beyond banks);
- the design and calibration;
- activation conditions and definitions.

Table 1

Characteristics framework of borrower-based measures for RRE

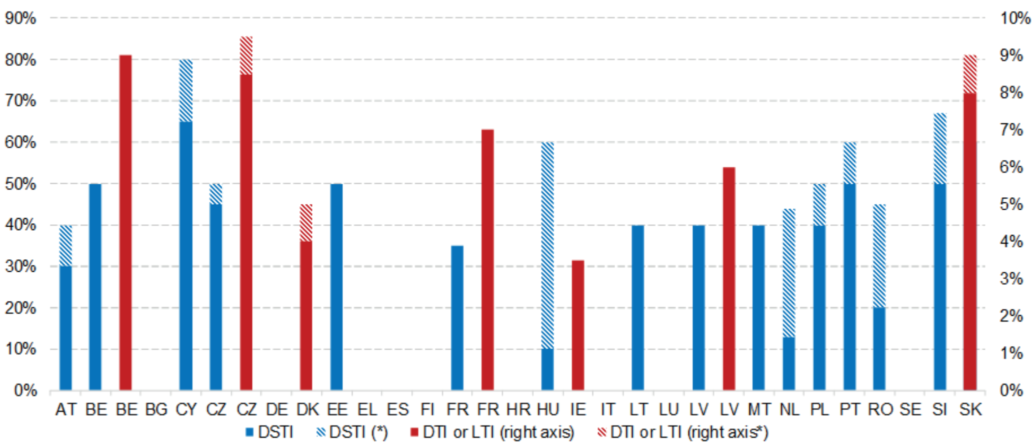
	Framework BBMs extends beyond banks	Activated BBMs are legally binding	Speed limits apply	Looser rules for young or first time buyers apply
Yes	16	16	11	7
No	9	5	10	14
Not Applicable	2	6	6	6

Source: DG FISMA, based on ESRB (2021), A Review of Macroprudential Policy in the EU in 2020, and on notifications of national authorities, available at https://www.esrb.europa.eu/national_policy/other/html/index.en.html.

For the design and calibration of BBMs, banks may have some flexibility to exceed the limits for a given share of loans (often referred to as 'speed limits') or less restrictive limits for certain groups of borrowers, for instance to make it easier for first-time buyers to access the housing market. Such exemptions apply in 11 of the 21 Member States that have activated borrower-based measures. The type and calibration of the income-based limits also varies across Member States, as figure 3 shows. Moreover, also the definitions of these ratios often differ among Member States.

Figure 3

Income-based limits as regards residential real estate (RRE)



Source: DG FISMA, based on ESRB (2021), A Review of Macroprudential Policy in the EU in 2020, and on notifications of national authorities, available at https://www.esrb.europa.eu/national_policy/other/html/index.en.html.
Note: Debt-service-to-income (DSTI) limits are displayed on the left-hand side and debt-to-income (DTI) or loan-to-income (LTI) limits on the right-hand side. Some Member use a combination of these, but only the DSTI limits are displayed (BE, CZ, FR). Definitions of income greatly vary across Member States. Shaded areas indicate the range of maximum income-based limits (i.e. up to DSTI/DTI/LTI*), for Member States that have differentiated limits. In Member States without a bar, no regulatory income-based limits apply. 'Speed limits' or exceptions are not taken into account in this chart. In Member States where they apply, lenders may extend a certain share of credit beyond the depicted limits.

3. *The review of the EU macroprudential framework for the banking sector and BBMs*

The macroprudential framework developed in the EU banking regulation, in the CRD and CRR, applies since 2014. Among other things, the framework addresses systemic risks stemming from pro-cyclical behavior of banks, structural weaknesses of banking sectors and banking groups that are too big to fail. Article 513 CRR mandates the Commission to review the macroprudential framework for the banking sector. This includes the question 'whether other types of instruments, such as borrower-based instruments, should be added to the macroprudential tools provided for in this Regulation and in Directive 2013/36/EU to complement capital-based instruments and to allow for the harmonised use of the instruments in the internal market; taking into account whether harmonised definitions of those instruments and the reporting of respective data at Union level are a prerequisite for the introduction of such instruments'.[4] The Commission has gathered considerable evidence through a Call for advice addressed to the European Banking Authority (EBA), ESRB, and European Central Bank. Their responses were delivered in March and April 2022.[5] Additionally, a targeted consultation run from 30 November 2021 to 18 March 2022, and resulted in around 50 responses, mostly from Member States, national authorities and individual banks and banking associations.[6]

While the framework has not yet been tested under severe stress, as banks did not experience significant losses in the Covid crisis due to fiscal and monetary interventions, the replies to the call for advice and public consultation provided valuable input, concerning three main themes. Firstly, respondents to the consultation generally considered that the buffer framework is effective in enhancing resilience against systemic risks, but is not working as intended to address cyclical, structural or exogenous shocks given that banks may be unwilling or unable to dip into their buffers.[7] Secondly, the responses highlight inconsistencies in the use of the

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4 Art. 513(1)(d) CRR.

5 The responses to the Call for Advice can be found on the websites of the EBA, ECB and ESRB: https://www.eba.europa.eu/eba-proposes-simplify-and-improve-macroprudential-framework, https://www.esrb.europa.eu/pub/pdf/other/esrb.reviewmacropruframeworkcfa.220331~5d81cb2173.en.pdf?7263115b46a985b4481328afd3f2326d, https://www.esrb.europa.eu/pub/pdf/other/esrb.reviewmacropruframeworkcfa.220331~5d81cb2173.en.pdf?7263115b46a985b4481328afd3f2326d.

6 For more information on the consultation, including the feedback statement, summarising the responses, see https://finance.ec.europa.eu/regulation-and-supervision/consultations/finance-2021-banking-macroprudential-framework_en.

7 A considerable number of respondents called for more releasable buffers. The ECB and ESRB responses to the Call for Advice extensively document the issues with the buffer framework.

macroprudential tools.[8] Thirdly, the macroprudential toolset is considered not fully appropriate to address conventional or new systemic risks.[9]

More specifically, a majority of the respondents to the public consultation is in favour of introducing a minimum set of borrower-based measures for residential real estate loans. Many of them would like to see this happening while keeping the power to activate and calibrate BBMs as a national prerogative, and without full harmonization of the design of the measures, their definitions, and indicators, given specificities of national real estate and mortgage markets. Several respondents highlight the importance of ensuring that the scope of BBMs would extend to non-banks to ensure their effectiveness and a level-playing field. Some other respondents consider introducing a minimum set of BBMs into EU law not crucial given differences in national mortgage markets, or prefer principle-based minimum standards that reflect idiosyncratic aspects of national markets. Some respondents suggest introducing a data collection for a minimum set of lending standards indicators, based on a common methodology, instead of introducing borrower-based measures.

The ESRB also advises to make a minimum but sufficient set of BBMs for RRE loans provided to natural persons available in all countries, while keeping decisions on activation, release, calibration, and overall design in the hands of national authorities. It advises to define BBMs using general principles based on the ESRB Recommendation on closing real estate data gaps, but to ensure that definitions are flexible and to ensure that BBMs are used throughout the EU. The ESRB also suggests introducing basic common standards for the governance of BBMs, to enhance data availability, and to harmonise the definitions related to RRE and CRE loans across EU reporting. Finally, it advises to include a legal basis for BBMs in both the Capital Requirements Directive, which applies to banks, and in the Mortgage Credit Directive,[10] which applies to all mortgage credit provided to consumers, regardless of the credit provider. Instead, the ECB advises to introduce a data collection requirement for a minimum set of lending standard indicators for RRE loans for monitoring purposes in the CRR, whereas the EBA does not discuss BBMs in its response to the Call for Advice.

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8 The consultation responses reveal support for a more consistent approach as regards the identification and buffer requirements for other systemically important institutions (O-SIIs, i.e., systemically important banks at the national level), as the use of these and other buffers and macroprudential measures differs widely across Member States. A majority of the respondents calls for more clarity on the distinctions between instruments to promote a more consistent use of tools by national authorities and to reduce overlaps. There is some support for strengthened EU-level monitoring and oversight of macroprudential stance within the current allocation of responsibilities between national and EU authorities. Various respondents call for for simplification of the framework and streamlined oversight procedures.

9 Yet, the majority view is that further analysis is needed before considering new macroprudential tools to address emerging risks, such as those related to climate and cyber.

10 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, OJ L 60, 34.

4. *Considerations regarding adding BBMs to the EU macroprudential toolkit*

So, what are the concerns related to the current situation of BBMs based on national law that have motivated these responses to the consultation and call for advice? Firstly, the availability of a minimum BBM toolkit is not ensured in each Member State, while this is necessary to address RRE vulnerabilities and systemic risks in a timely and targeted manner. Secondly, differences in design, definitions and use could be a source of fragmentation in the internal market and could complicate reciprocation. This could give rise to cross-border leakages. The use of instruments based on national law may heighten the incidence of cross-country leakages and hamper the process of supervisory convergence. Additionally, the lack of harmonised data and definitions may complicate cross-country comparisons of risks and assessments of the proportionality, appropriateness and sufficiency of policies and their interactions.

Adding a minimum set of BBMs to the EU macroprudential toolkit would ensure the availability of these instruments in each Member State, increasing the ability to address systemic risks and reducing obstacles to do so. Additionally, minimum harmonisation of BBMs would allow to ensure the conditions for the effective use of BBMs, in terms of governance, transparency and their effectiveness in a cross-border context. Even if not fully harmonizing definitions, these could still be made more comparable. Furthermore, possible accompanying guidance on methodologies for assessing risks and the use of these tools could constitute a step towards harmonisation and a common understanding of the use of BBMs. This could be helpful in addressing real estate risks, also across borders, as it enables reciprocity for countries where BBMs do not apply to foreign lenders. However, minimum harmonisation of BBMs with flexibility in definitions and design would also mean that significant differences remain, and concerns cannot be fully addressed. In terms of scope, the CRD is entity-based prudential regulation for banks. Using this act as a legal basis for BBMs in the EU legal toolkit would ensure that BBMs can be applied to banks in each Member State, but would leave it to Member States to extend the scope beyond banks. Including a legal basis in the Mortgage Credit Directive would mean that activated BBMs apply to all mortgage credit provided to consumers.

Another consideration is whether adding BBMs to the EU legal toolkit could bring them within the scope of the topping-up powers of the ECB as regards their application for banks, depending on the legal configuration. In the Single Supervisory Mechanism, the ECB has macroprudential tasks, next to and on top of the national authorities in charge, which are primarily responsible for macroprudential policy in their Member State.[11] Based on Art. 5 of the SSM Regulation, the ECB can top-up national macroprudential measures that apply at the level of banks, if deemed necessary, and subject to the procedures provided

[11] Art. 5 of 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.

for in the CRR and CRD for the respective instruments.[12] This topping-up power of the ECB reduces the risk of inaction bias. It applies to the capital buffers, risk-weight measures and other macroprudential tools provided for in the CRR and CRD. It does not apply to BBMs based on national law, in light of the last paragraph of Art. 1 of the SSM Regulation: 'This Regulation is also without prejudice to the responsibilities and related powers of the competent or designated authorities of the participating Member States to apply macroprudential tools not provided for in relevant acts of Union law.' Therefore, if minimum harmonisation of BBMs and adding a minimum set of BBMs with a macroprudential purpose to the EU macroprudential toolkit would bring these instruments into the scope of the ECB's topping-up powers, meaning that ECB could decide to tighten such limits, if deemed necessary.

Some respondents to public consultation and call for advice have suggested mandatory reporting on mortgage lending standards. Particularly the ECB considers the enhanced comparability of risk assessments of the RRE sector and of the prudential policy stance on BBMs across EU jurisdictions as an important and desired benefit. Indeed, given the central role of RRE markets for the stability of the financial system and the economies of Member States and the Union, having harmonised granular, timely and comparable data is necessary to enable the early identification of rising vulnerabilities and potential systemic risks, and facilitates reliable and robust cross-country analyses of risks and policy stances. Harmonising reporting standards may also contribute to common practices and increasingly similar frameworks.

5. *Concluding remarks*

The work on the macroprudential review will continue. This involves assessing the effectiveness and consistency of tools, like risk-weight measures and sectoral systemic risk buffers, in addressing systemic risks and vulnerabilities related to real estate markets across the EU, and options to improve this. These assessments are also linked to broader discussions around buffer usability, in order to ensure that banks would be able absorb possible losses, for instance related to real estate market corrections, while maintaining the provision of credit. The diversity in national real estate markets may act as a constraint on harmonisation of BBMs, due to the wish of stakeholders and the need to adapt these tools to

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12 Specifically, according to Art. 5(2) Regulation 1024/2013, 'The ECB may, if deemed necessary, instead of the national competent authorities or national designated authorities of the participating Member State, apply higher requirements for capital buffers than applied by the national competent authorities or national designated authorities of participating Member States to be held by credit institutions at the relevant level in accordance with relevant Union law in addition to own funds requirements referred to in point (d) of Article 4(1) of this Regulation, including countercyclical buffer rates, subject to the conditions set out in paragraphs 4 and 5 of this Article, and apply more stringent measures aimed at addressing systemic or macroprudential risks at the level of credit institutions subject to the procedures set out in the Regulation (EU) No 575/2013 and Directive 2013/36/EU in the cases specifically set out in relevant Union law'.

national circumstances and to keep the powers to apply and calibrate them fully at national level. The Commission will continue analysing the policy options. In the meantime, it is also possible that, due to sharing experiences and learning, the practice of using and calibrating BBMs in EU Member States may continue to converge in the coming years.

A national experience: Italy

Alessio De Vincenzo, Giuseppe Napoletano[*]

Summary: *1. The features of borrower-based measures in the new Italian framework – 2. Criteria for the activation of borrower-based measures – 3. Recent developments in the Italian real estate market – 4. The legal basis of borrower-based measures in Italy: an illustrious ancestor. Article 38(2) of the Consolidated Banking Law on real estate credit – 5. A new legal framework for BBMs in Italy – 6. Breach of the caps: legal consequences*

1. The features of borrower-based measures in the new Italian framework

A new legal framework for borrower-based measures has recently been introduced in Italy.[1] These instruments, which are not harmonized at European level, aim to strengthen the resilience of the financial system by imposing limits on borrowers' risk-taking. They are typically used to counter systemic risks deriving from the real estate market and high or rising indebtedness of households or non-financial firms.

If deemed necessary to preserve the stability of the national financial system, the Bank of Italy can impose a number of restrictions on new loans related to the financial situation of borrowers or to the characteristics of the loans. The measures include limits on: the loan-to-value (LTV) and the loan-to-income (LTI) ratios; the debt-to-income (DTI) and the debt service-to-income (DSTI) ratios; leverage (defined as the ratio of total debt to equity); maximum maturity and amortization requirements of the loans. In order to target specific vulnerabilities that may arise, the limits can be applied: (a) to loans to households or firms; (b) with or without exemption thresholds; (c) in the same way to all loans or differentiating based on borrowers' and loans' characteristics;[2] (d) at national level or for specific geographical areas; (e) alone or in combination; (f) if deemed as necessary, also simultaneously with other types of macroprudential instruments.

The Bank of Italy can, at any time, add to or modify the list of borrower-based measures under national legislation, taking into account, inter alia, possible vulnerabilities arising from developments in the real estate market and

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1 See Circular 285, Part 3, Chapter 12 (only in Italian).

2 In particular, specific measures can be applied based on the: (a) borrower category (households or firms); (b) purpose of the loan; (c) sector of economic activity in the case of legal persons; (d) risk category of the entity; (e) type of guarantee (residential or commercial property, or other type of guarantees); (f) other characteristics of the loans.

the capacity of the macroprudential measures already in place to avert potential systemic vulnerabilities.

In addition to banks, the Bank of Italy may apply borrower-based measures also to: financial intermediaries that, like banks, carry out the activity of granting loans in any form to the public; payment institutions and e-money institutions, which can grant loans only in close relation to the payment services provided. This ensures a greater degree of effectiveness of the measures, which aim to prevent systemic risk regardless of the type of financial institution providing credit.

2. *Criteria for the activation of borrower-based measures*

In order to identify current and future systemic risks and assess the need to activate BBMs, the Bank of Italy monitors the indicators identified by the ESRB[3] as well as other indicators or models (including stress tests) able to signal the building up of vulnerabilities in the national RE market.

In the presence of high vulnerabilities, which can give rise to systemic risks, the Bank of Italy may adopt one or more BBMs that are – in line with the ESRB guidelines – appropriate and sufficient to prevent or mitigate the risks considering, if possible, also any cross-border effects deriving from their application.

A measure is considered appropriate if, taking into account the phase of the national credit cycle and the measures possibly adopted by different policymakers (for example, monetary and fiscal policy decisions), it is the most suitable to respond to the identified risks compared to other macroprudential instruments. An appropriate measure is also considered sufficient if it is capable of achieving the objective of preventing or mitigating the identified vulnerabilities and entails over time advantages greater than the costs deriving from its implementation.

When introduced, the Bank of Italy will periodically examine the impact of the BBMs adopted and, if necessary on the basis of new evidence, could recalibrate the measures already in place and/or activate new measures (in combination or in alternative to those already activated).

3. *Recent developments in the Italian real estate market*

In Italy nominal housing prices had started to rise since the second half of 2021, but less if compared with other countries (fig. 1). In real terms the increase was more contained and the growth rate became negative in June 2022 (fig. 2). Although sales currently stand at levels higher than in the last six months of 2019, prior to the pandemic, they have slowed down since the end of 2021.

[3] See ESRB/2016/14 and ESRB/2019/3.

Loans to households for house purchase continue to grow; in June 2022 the annual growth rate was 5.5% (fig. 3). Since 2015, the share of fixed-rate mortgages (FRMs) has increased, converging to the euro-area average. In the first semester of 2022, 77% of new mortgages were FRM; overall, the stock of FRM was equal to 62% of total mortgages in June.

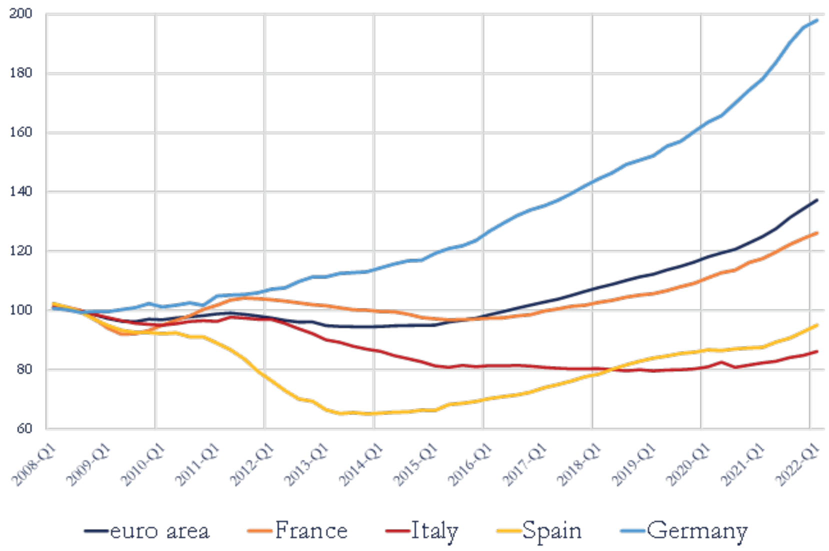
In recent years the prolonged weakness of the real estate sector, which started at the end of 2006 and became more intense in the period of the sovereign debt crisis, has had a significant impact on bank balance sheets. The vulnerabilities stemming from the commercial real estate sector, in particular, are reflected in a high share of gross non-performing loans in the CRE portfolio[4] (24% in June 2022), well above the weight of CRE loans on total credit (8%). The quality of credit granted to households is instead much better, mainly thanks to their low indebtedness, also by international standards: the share of gross non-performing loans in the RRE portfolio[5] is 16%, against a share of total loans of 25% (fig. 4).

In the first half of 2022 the overall vulnerability of Italian banks stemming from real estate exposures was at historically low levels (fig. 5). The Bank of Italy continues to closely monitor the RE sector, also in light of a possible worsening of the economic outlook.

Figures

Figure 1

Residential property prices
(indices: 2008=100)



Sources: Based on data from the ECB and Istat.

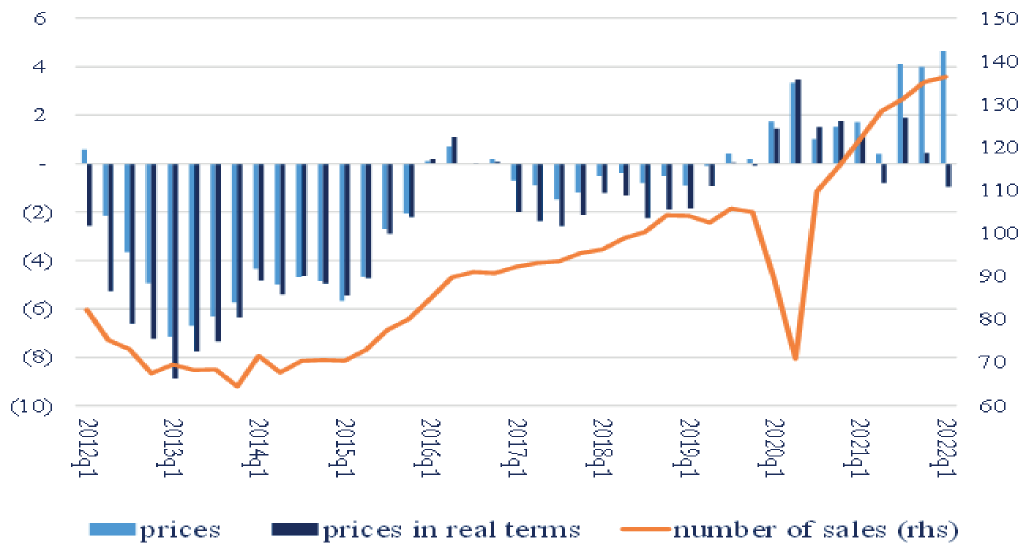
[4] CRE loans are defined as loans to firms collateralized by a commercial real estate property.

[5] RRE loans are granted to households and collateralized by a residential real estate property.

Figure 2

Dwellings in Italy

(year-on-year changes and indices: 2015=100)

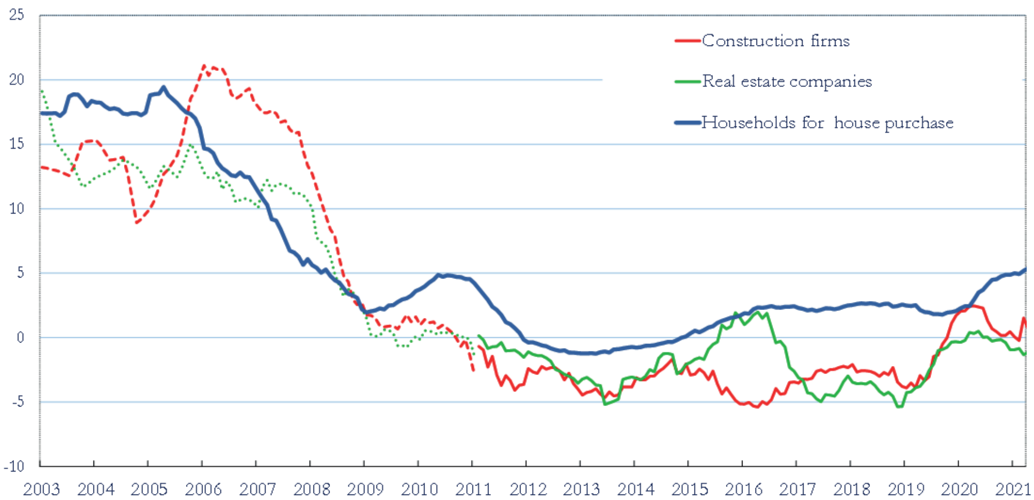


Sources: Based on data from the Bank of Italy, ISTAT and Osservatorio del Mercato Immobiliare (OMI).

Figure 3

Growth rates of real estate loans

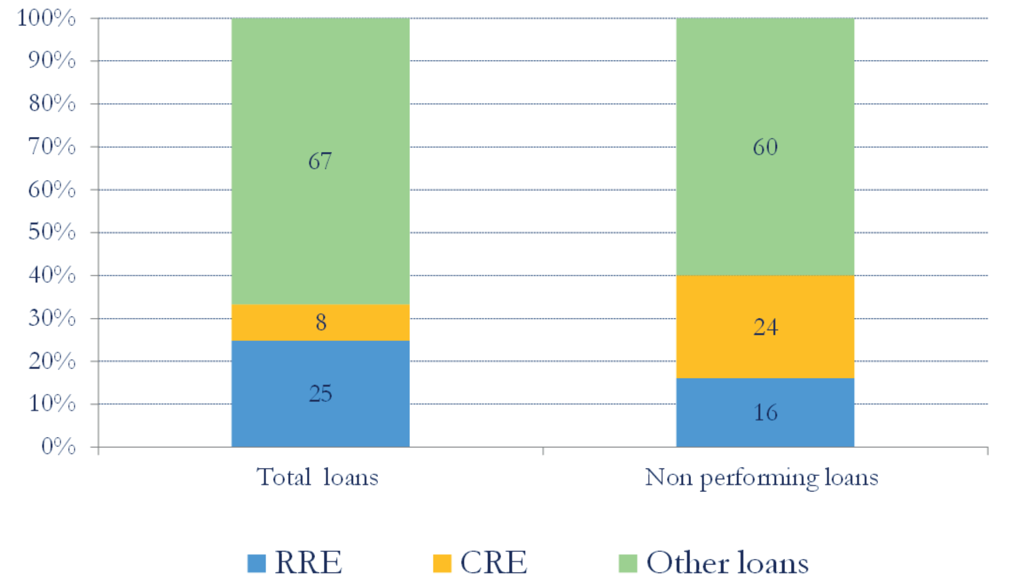
(year-on-year per cent changes)



Sources: Credit register and Supervisory reports.

Figure 4

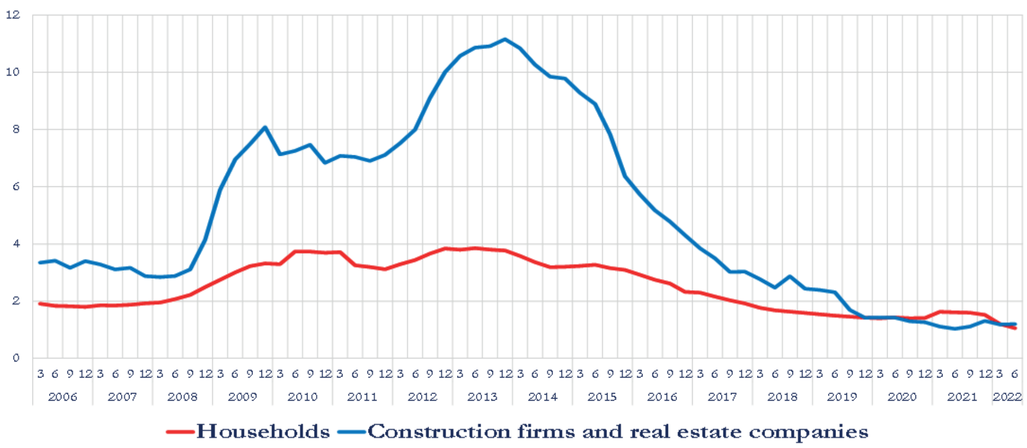
Share of RRE and CRE loans over total
(June 2022; per cent)



Source: Finrep. Note: RRE loans are those granted to households and collateralized by a residential real estate (RRE) property; CRE loans are those granted to firms and collateralized by a commercial real estate (CRE) property.

Figure 5

Indicators of bank vulnerability stemming from the real estate market
(quarterly data; per cent)



Note: Bank vulnerability is measured by the ratio of the flow of new non-performing loans in the last 4 quarters to the average of bank capital and reserves in the same period. The projections are represented graphically by the median values and from the 10th and 90th percentiles. For the methodology, see F. Ciocchetta and W. Cornacchia, 'Assessing financial stability risks from the real estate market in Italy: an update', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 493, 2019.

4. *The legal basis of borrower-based measures in Italy: an illustrious ancestor. Article 38(2) of the Consolidated Banking Law on real estate credit*

Under the Italian Consolidated Banking Law (CBL) "*Banca d'Italia, according to the deliberations of the Interministerial Committee for Credit and Savings, establishes the maximum amount of loans, with reference to the value of the mortgaged properties or to the cost of the works to be executed upon them*" (Article 38 of Legislative Decree 1 September 1993, No 385).

The quoted provision is currently in force. It derives in turn from the Banking Law of 1936-38, which empowered the 'Ispettorato del credito' (Credit Inspectorate, at the time a public body chaired by the Governor of Banca d'Italia, that supported the body under the control of the Government) to fix the cap to any form of financing, as well as to set up rules and conditions to cut them down in case the allowed credit exceeded the cap (Article 35(2) Decree-Law 12 March 1936, No 375 – Law 7 March 1938, No 141).

It is notable that the CBL links a number of important advantages for credit firms and borrowers which, in their contracts, respect the cap that has been fixed according to the above-mentioned provision.

The purpose of the power of Banca d'Italia under Article 38 of the CBL is quite wide, as all its powers are to be exercised "*having regard to the sound and prudent management of the persons subject to supervision, to the overall stability, efficiency and competitiveness of the financial system and to compliance with provisions concerning credit*" (Article 5(1) CBL).

As a matter of fact, the power to set caps for the real estate credit has been exercised to ensure a structural measure, apt to foster the resilience of each bank and as a whole of the banking system, while preventing borrowers from unsustainable indebtedness: it's long time that the cap is fixed at 80% of the value of the mortgaged property or to the cost of the work to be done on that property. The cap may be raised where additional guarantees are conceded.[6]

5. *A new legal framework for BBMs in Italy*

Bank of Italy was recently qualified by the Italian legislator as designated authority for macroprudential purposes (Article 53-*ter*(1) CBL, that is entitled "*macroprudential measures*").

More precisely, Bank of Italy is the designated authority in view of the adoption of the "*measures provided for under Article 5 of Regulation (EU) No 1024 of 2013*" (the SSM Regulation). Article 5(1) of SSM Regulation stipulates that "*the national competent authorities or national designated authorities of the*

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[6] Banca d'Italia, Circular No 229 of 21 April 1999, as modified, Title V, Chapter 1, Section II.

participating Member States shall apply requirements for capital buffers to be held by credit institutions at the relevant level in accordance with relevant Union law in addition to own funds requirements referred to in point (d) of Article 4(1) of this Regulation, including countercyclical buffer rates, and any other measures aimed at addressing systemic or macro-prudential risks provided for, and subject to the procedures set out, in the Regulation (EU) No 575/2013 and Directive 2013/36/EU in the cases specifically set out in relevant Union law".

The reference to Article 5 of SSMR is complemented by a further rule that allows Bank of Italy to exercise all of its supervisory powers under the CBL "*for macroprudential purposes, even on significant institutions*" (53-*ter*(2) CBL).

It can be thus activated for macroprudential purposes a wide range of supervisory powers that were originally conceived for microprudential purposes but that had already adapted for other purposes in the last decades, in coherence with initiatives taken at international level.

Hence, Article 53-*ter*(2) CBL has to be read in connection, for instance, with (the supervisory powers provided for under) Article 51 (informative powers), 53 (*inter alia* providing in Paragraph 1 for measures aimed at the "*limitation of risk in its various forms*"), 53-*bis* (where Bank of Italy is entrusted e.g. with the power of adopting "*specific measures regarding one or more banks or the whole banking system*" in the matters referred to in Article 53(1) and therefore also to contain risks), 54 (Inspections), 117 (whose Paragraph 8 declares the nullity of contracts which content diverges from that determined by Bank of Italy) CBL.

The open reference to "macroprudential purposes" combines with the range of powers that were referred to above. It is therefore possible to expand macroprudential policies on banks at national level beyond the boundaries of the current EU macroprudential provisions, also to encompass borrower-based measures.

The same drafting technique was adopted in the CBL to allow the exercise for macroprudential purposes of the powers that Bank of Italy already had under the CBL towards – not only banks, but also – financial intermediaries (Article 108(1) CBL), electronic money institutions (Article 114-*quinquies*.2 CBL), payment institutions (Article 114-*quaterdecies* CBL).

Rule of law is warranted, in that the macroprudential purposes pursued by Bank of Italy are embedded in the CBL; also in the CBL can be easily identified the categories of firms that are subject to those powers, as well as the matters that may be potentially involved and the kind of powers that the Authority may exercise.

At the same time, a proper degree of flexibility is ensured by the law design.

Under the described legal framework, borrower-based measures adopted by Bank of Italy may be applicable to all loans or to some of them, based on customer features (e.g. physical person or also legal entities), type of loans (e.g. real estate, consumer), geographic location of the real estate, with or without exemption thresholds, alone or combined with other BBMs. No legal impediments specifically prevent Bank of Italy from combining BBMs with other macroprudential measures, e.g. with capital-based measures.

The rules recently introduced by Bank of Italy[7] are based on the above principles.

Of course, that flexibility shall be used according to criteria that have to be previously established, as the macroprudential studies and practice advance.

There are some limits to the power of Bank of Italy as regards borrower-based measures. Most of those limits are connected to the qualification of the Italian BBMs as supervisory powers.

Therefore, requirements established by Bank of Italy with reference to BBMs shall apply to supervised intermediaries. They do not apply directly to loan contracts, so that they apply only to Italian intermediaries, thus leaving room for arbitration in absence of reciprocation. National rules and powers on BBMs may apply to Italian banks and financial firms as identified in the law, to Italian branches of non-EU banks and to non-EU banks operating directly in Italy without establishing a branch.

Those supervised entities shall apply the requirements on BBMs, by transposing them in the loan contracts that they sign with their customers.

6. *Breach of the caps: legal consequences*

What is not clear is what happens if the loan actually conceded exceeds the cap provided for by the Bank of Italy's rules.

There is no doubt on the relevance of the breach as regards the supervisory relationship between the Authority and the supervised firm.

It is not sure, however, if there might be further consequences directly affecting the contract, aside the case of a violation of Article 117(8) CBL, above mentioned.

Articles 38 and 53-*ter* CBL are silent on the specific topic, and the issue is not yet settled by the case-law, called upon deciding several cases falling under Article 38 CBL.

According to some findings the cap provided for under Article 38 CBL is just the content of a behavioural rule addressed to banks, so that its breach may have only supervisory effects.

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[7] Circular No 285 of 17 December 2013, Part 3, Chapter 12, introduced on 22 February 2022.

In other cases, judges highlighted that the cap is provided for by the CBL with an aim of public interest and it directly touches upon the object of the loan contract; thus its breach implies (also) the nullity of the contract. It could be also considered whether the deviation from the public interest concerns only the *quid* of the loan that exceeds the cap provided by the specific BBM.

According to a further approach, public interest surely underlies the cap. Nonetheless, the breach of the cap would not imply any nullity of the contract; rather, it would impose the disapplication of the various advantages that the CBL connects to the respect of the cap.

The Italian Corte di Cassazione – competent on the last degree of civil jurisdiction, dedicated to the correct application of law – is currently evaluating the issue within its 'United Sections', in order to ensure the most comprehensive judgement (Order No 4117/2022).[8]

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8 Just few days after the seminar, the United Sections of Corte di Cassazione decided the issue in the sense that the breach of the cap does not cause the nullity of the contract (sentence No 33719 of 16 November 2022, decided on the 27th of September 2022).

Legal challenges of borrower-based measures

Anat Keller[*]

Thank you very much for inviting me to speak at the seminar. In the next 25 minutes, I would like to set out my perspective on the key legal challenges in activating, calibrating and withdrawing borrower-based tools. I would like to divide my presentation into the following key areas: Mandate, decision-making process and finally accountability and transparency – all these, of course, through the lens of borrower-based tools.[1]

I will begin by discussing the unique features of borrower-based measures (BBMs).

First, BBM are increasingly judged to work better in combination. In turn, it is difficult to isolate or disentangle the effect of a single macroprudential tool from other macroprudential tools or policy tools that are often used in conjunction.

The effectiveness of macroprudential tools, particularly BBMs, is also country dependent. Evidence that emerges on their effectiveness is often contextual and subject to particularities of the setting and policy mix and may not provide a good indication of the suitability of the tools and their effectiveness across countries.

Second, BBM are known to have a potential distributional effect and are often viewed as cutting across lenders' judgment on the creditworthiness of borrowers, potentially reducing access to finance for often younger and less wealthy groups. Politicians are particularly keen to support these segments of the electorate and promote the democratisation of homeownership. We don't need to look far with the UK government announcing a few months ago 'Generation Buy" pledging 95% fixed mortgages for first-time buyers. And while the tools' adverse effect on these segments of the population will be immediate and visible, the wider benefit to the society will not be easily quantified let alone felt at the implementation stage. This makes rationing the decision to the public even more difficult. Similar to other macroprudential measures, restrictive measures will likely take place when the danger to financial stability is least apparent, rendering the decision unpopular. Therefore, when activating BBM the pressure on the macroprudential authority to avoid, delay or tune down the implementation of these unpopular tools may increase. It also means that inaction bias will be particularly strong when it comes to these measures.

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[1] The discussion is based on A. Keller, *Legal Foundations of Macroprudential Policy: An Interdisciplinary Approach*, Cambridge, 2020.

Let me give an example. The decision of the Central Bank of Israel to use LTV ratio as a macroprudential tool led to a great deal of media and public debate, criticising the policy for discriminating against young couples and favouring foreign investors. It brought deeper issues of social inequalities to the surface.

Third, when activating these tools macroprudential authorities must consider potential leakages and regulatory arbitrage. Where the leakages are domestic, they can be addressed by applying broader-based definitions and applications of tools that affect all exposures, being blind, for instance, to the type of lender and whether it is a bank or non-bank. This can reduce the scope for circumvention and migration of activity to other (less regulated) parts of the financial system. Still, when setting BBMs at the regional level, certain flexibility at the national level must be maintained to adjust them to the country's specificities and heterogeneities. This means considering factors such as the size, structure and complexity of the financial system, economic structure, the strength of the legal framework, availability of data for macroprudential purposes and measures of macroeconomic, structural and social policies in place. Indeed, the ESRB recommendations often reiterate the importance of national specificities, and the principle of proportionality is enshrined in assessing compliance with the recommendations.

There are other mechanisms available to address regulatory arbitrage. These include Reciprocity and the expediency of the implementation period that can mitigate front-running.

Now that we understand the unique features and challenges in activating and calibrating BBMs – we need to ask how the legal framework and the manner in which authorities make decisions, can address these challenges.

As always in life, things come in 3's so I would like to present to you three key suggestions.

The first relates to the mandate.

The second relates to the decision-making process of the macroprudential authority, whether it should follow and publish a cost-benefit analysis and the importance of exchanging information and considering other policy areas.

The third relates to the need for strong transparency and accountability mechanisms but I will go beyond general observations and suggest ways to achieve that.

Before analysing these aspects, I would like to point out that there are other legal concerns that will affect the effectiveness of macroprudential policymaking. The institutional structure of the macroprudential authority, for instance, can affect the degree of inaction bias and in turn, the ability of the macroprudential authority to implement these tools and not succumb to political and industry pressure. This is particularly important when thinking about BBMs. A macroprudential authority that has, for instance, external members would be better equipped to counter inaction bias and minimise groupthink. There are other determinants, that go beyond composition that should be considered. As such, the decision rule as set in legislation could affect the level of genuine deliberations in meetings. A consensus rule can facilitate successful implementation and make it easier to project a clear message when addressing the public but there is a real concern that a unanimous decision rule may inhibit plurality of views and there is also a risk of paralysis when consensus cannot be reached. A middle ground can direct to reaching a consensus when possible, failing that – we can follow a majority rule and in the event of a tied vote – the chair can have a casting vote.[2]

The core of implementing macroprudential tools, including BBMs is systemic risk. But systemic risk is not a static concept; it evolves and in recent years, is understood to include also transitional and physical risks due to losses resulting from climate change.

If we really want to tackle those risks, we need not only to identify them as risks but also to adjust the tools we have. Suggestions are being made for BBMs to be differentiated according to various features of the underlying asset.

But expanded remits could potentially have an implication on the legitimacy and credibility of macroprudential authorities.

With regard to legitimacy, any expanded remit cannot go beyond the scope of the mandate and the macroprudential toolkit. Getting this first step right is particularly important as the democratic legitimacy of macroprudential authorities is already a thorny issue. Unelected regulatory power often goes with the need to strengthen legitimacy.

Expanding remits may complicate the task of ensuring effective accountability of macroprudential authorities. We should, therefore, consider whether we need to adapt accountability mechanisms to reflect that change. I will get back to this point towards the end of my presentation.

With regard to credibility – well, broader remit in general and BBMs that mitigate climate-related financial risks, in particular, may undermine credibility. Evidence-based decision-making in climate-related financial risks is challenging and any error could undermine confidence in the ability of a macroprudential authority. Utilising such tools could also have unintended consequences. For instance, it could go against the UK government's objective to level up the north with the south by influencing the demand for housing in the south. And this would bring a macroprudential authority into the political field, jeopardising their independence. In the EU, these unintended consequences might be different. They would touch at the heart of the tension between alignment and a level playing field and the need to tailor these tools to the specific circumstances of Member States.

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2 This is the case in the Financial Policy Committee's decision making rule; see Bank of England Act 1998, Schedule 2A, paras 11(3)-(5).

So expanding remits and the associated risk of undermining credibility means that we should assess whether BBMs (rather than fiscal or monetary toolkits) are the most effective climate policy tools and if so – we should consider whether they should be accompanied by enhanced decision-making processes, accountability and transparency mechanisms.

Let me move on to discuss the legal aspects of the decision-making process.

Should we adopt a cost-benefit analysis when deciding whether to deploy or withdraw tools as a procedural requirement and one that is transparent?

Given that these tools could have wide-ranging impacts as well as specific distributional consequences, the benefits of utilising a cost-benefit analysis in the various phases of macroprudential policy-making are sizable. Cost-benefit analysis provides a structured method for macroprudential authorities to conduct informed deliberation and consider the effectiveness of alternative measures and the most suitable and targeted tools to address the specific source of systemic risk. It can also assist authorities in bringing to light the unintended consequences of its policy decision and identifying potential interactions with other policy areas. For instance, in taking a cost-benefit approach prior to the activation of BBMs, a macroprudential authority will be forced to consider wider housing and socio-economic factors. Finally, a more fine-grained analysis promotes transparency of the decision-making process and the reasons behind policy making and provides a structured framework and benchmark for challenging and where appropriate, holding the macroprudential authority to account for its actions (or inaction). When implementing BBMs this is particularly important since it promotes a more evidence-based process thus insulating, to some extent, the authority from unwanted political and industry pressure. This approach also fits in with the ESRB's recommendation on operationalising macroprudential policy.

In the UK, a cost-benefit analysis is required whenever reasonably practicable and its publication is viewed as a vital accountability mechanism of the FPC. Of course, macroprudential authorities should also acknowledge the limitations of this approach. For instance, a cost-benefit analysis and its publication may incentivise macroprudential authorities to sit and wait until further data is collected and deeper analysis can be performed resulting in "paralysis by analysis". But overall, it moves policy decisions away from a subjective and intuitive judgment and unaccountable criteria to a more neutral and evidence-based framework. The accountability of macroprudential authorities is of paramount importance and high-quality, rigorous cost-benefit analysis should be a key legal mechanism for holding them to account for their actions.

The second point is that prior to activating or withdrawing sectoral housing tools, macroprudential authorities should consider the implications of macroeconomic policies, prudential supervision, building (zoning) regulations and other structural policies. These policies can impact the demand and supply of housing markets and the cost and ease of financing house purchases. This is trite knowledge.

Coordination mechanisms should form part of the legal framework and will depend on the specific institutional structure (for instance, are there cross-membership across authorities that promote this exchange of information?). But the more interesting legal question is whether there should be a hierarchy across policy objectives. There are differing views here but until a more solid body of evidence on the interaction between policies is gathered, it is wiser to resort to a softer mode of coordination such as "have regard to the actions of other authorities" or avoid exercising functions in a way that would prejudice the advancement of other authorities.

My third recommendation relates to the **need for a diversity of channels of accountability arrangements**.

In the macroprudential setting, it is difficult to maintain accountability given that there is no clear benchmark against which the success of the macroprudential authority in achieving its mandate can be judged. It can also be difficult to identify causal effects between specific policy measures and the outcomes in terms of financial stability and thus difficult to link and attribute accountability to policy decisions. After all, the stability of the financial system depends on the culmination of multiple contingencies and policy measures.

While the independence of macroprudential authorities is similar, to some extent, to central banks' independence, accountability arrangements should be richer to reflect these inherent limitations. This means that, instead of focusing solely on the ex-post control of policy outputs, the focus shifts to ex-ante monitoring tools, including adherence to administrative procedures. But do not be mistaken, these administrative regulatory processes have a substantive role. These regulatory processes narrow the agency's decision space so that it exercises power in a non-arbitrary and open way. Meaningful use of process-oriented accountability can assist macroprudential authorities in learning the boundaries of their mandate, instilling rigour in their analysis prior to activating the tools. **What are these processes?** We have already discussed a cost-benefit analysis but there are other mechanisms such as a consultation period that seeks feedback from external stakeholders. A macroprudential authority should maintain the ability to waive consultation requirements in order to take action quickly if needed.

These mechanisms must be enhanced and backed by other checks and balances and traditional forms of accountability of judicial review and parliamentary scrutiny. Otherwise, there is a real risk that they will become a box-ticking exercise.

Finally, transparency and clear communication of activation and calibration of tools can facilitate accountability and foster the achievement of the macroprudential objective. The timing of the communication of the planned measures should be considered carefully. When done too early it can result in strong lobbying and front running.

But what kind of communication should macroprudential authorities adopt? We should distinguish between internal and external communication. Where the macroprudential authority is a committee, external statements should display a high degree of consistency amongst the statements of individual committee members to show a unified "front line". A diversified communication might undermine clarity and common understanding of the public and financial markets thus creating a cacophony. On the other hand, it is also important to demonstrate that the decision-making process has a deliberative nature and takes into account a diversity of views. **How do we find the right balance?** To maximise the benefits of transparency, much wider and deeper engagement with society is needed, in the form and manner that will increase their understanding and trust. A decision to tighten policy by implementing BBMs will be more easily digestible if households and firms understand the rationale and outcome of policy decisions and their contribution to financial stability. Communication channels can be adjusted to make them more digestible and reach a wider audience. The FPC for instance complements its approximately 100-page FSR with visual summaries and short tweets.

Publication of records of meetings is also a key transparency tool but publications of opinions of individual members could be problematic since it may inject short-term political and personal career factors into deliberations and voting behaviour. So there may be a case for a summary of deliberations but without identifying particular members and subjecting the publication to statutory exceptions, most importantly the public interest.

Let me end my presentation with a recent example from a good friend across the sea.[3] And while I am aware the title of this workshop is BBMs in the EU, I think that this example demonstrates how the legal framework can address and alleviate many of the challenges in activating and withdrawing BBMs.

In 2014, the FPC introduced two Recommendations to guard against a loosening in mortgage underwriting standards: 'LTI flow limit' which limits the number of mortgages that can be extended at loan to income ratios at or greater than 4.5 to no more than 15% of the total number of new mortgage loans; and the 'affordability test' which specifies a stress interest rate for lenders when assessing prospective borrowers' ability to repay a mortgage. These measures came alongside an existing affordability test, a conduct of business tool.

In June 2022, the FPC decided to withdraw the affordability test Recommendation, but maintain the LTI flow limit alongside the wider assessment

[3] See the record of the Financial Policy Committee meetings held on 17 and 25 June 2014 available at https://www.bankofengland.co.uk/-/media/boe/files/record/2014/financial-policy-committee-meeting-june-2014.pdf?la=en&hash=1EDFFE417F4AD9E2D0AD13B8A8A73BACF6051214.

of affordability. It conducted a cost-benefit analysis and noted some concerns with how the affordability test has operated.[4]

What can we learn from this example?

First, we can see in the communication of the FPC, acknowledgement of the interaction between the primary financial stability objective and economic growth as a secondary objective. The FPC emphasised in its communication that whilst the affordability test is currently having a limited impact, withdrawing it could result in some improvements in access to mortgages, being consistent with its secondary objective of economic growth. In addition, we can see from communications that the FPC is also transparent about opposing views voiced during the consultation phase. This approach can ultimately increase understanding and trust in policy decisions.

Second, the FPC's decision followed close coordination with other authorities and considered the application of conduct of business affordability rules. This is enshrined in a legal obligation to avoid exercising its functions in a way that would prejudice the advancement of the objectives of the prudential and conduct of business regulators.

Third, the timing of withdrawal and its announcement is of the essence. The FPC provided a very short notice for the change, It rejected feedback to extend that period arguing that a longer notice period could strengthen incentives to delay mortgage applications. The timing of the decision (though this was not stated) was also before the government scheme of Help to Buy to first-time buyers ended.

4 In particular, the stress rate encapsulated in the test has remained broadly static reflecting stickiness in reversion rates despite the fall in average quoted mortgage rates. See *An FPC Response - Consultation on withdrawal of the affordability test Recommendation*, available at https://www.bankofengland.co.uk/paper/2022/an-fpc-response-consultation-on-withdrawal-of-the-affordability-test-recommendation.

Appendix

I. European Systemic Risk Board

RECOMMENDATION

of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1) (2013/C 170/01)

THE GENERAL BOARD OF THE EUROPEAN SYSTEMIC RISK BOARD,

Having regard to Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board,[1] and in particular Article 3(2)(b), (d) and (f) and Articles 16 to 18 thereof,

Having regard to Decision ESRB/2011/1 of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board,[2] and in particular Article 15(3)(e) and Articles 18 to 20 thereof,

Whereas:

(1) Financial stability is a precondition for the financial system to provide credit, supporting sustainable economic growth. The financial crisis has clearly revealed the need for macro-prudential oversight that mitigates and prevents systemic risk in the financial system. The objective of this Recommendation is to take a necessary next step towards an operational macro-prudential oversight.

(2) Resilience against systemic risks in the Union depends on establishing a sound macro-prudential policy framework alongside the micro-prudential supervision. This Recommendation follows up on Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities,[3] by elaborating on intermediate objectives and instruments of macro-prudential policy.

(3) Recommendation ESRB/2011/3 requires Member States to designate an authority entrusted with the conduct of macro-prudential policy. Similarly, the proposed new framework establishing prudential requirements for credit institutions (hereinafter the 'CRD IV/CRR') requires Member States to set up a designated authority responsible for taking measures necessary to prevent or mitigate systemic risk or macro-prudential risks posing a threat to financial stability at national level.[4]

(4) The ultimate objective of macro-prudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth. Recommendation ESRB/2011/3 refers to the identification of intermediate policy objectives as operational specifications of the ultimate objective. Identifying

intermediate objectives makes macro-prudential policy more operational, transparent and accountable and provides an economic basis for the selection of instruments.

(5) Moreover, the effectiveness of macro-prudential policy in the Union depends on the establishment of a set of macro-prudential instruments to be effectively applied by the relevant macro-prudential authorities guided by a set of indicators, alongside expert judgement. Macro-prudential authorities should have under their direct control or under recommendation powers the necessary macro-prudential instruments, namely one or more instruments for each intermediate objective of macro-prudential policy. Instruments used to tighten the macro-prudential policy stance shall be released if deemed appropriate to stabilise the financial cycle. Macro-prudential instruments could be applied to broad or targeted categories of exposures, the latter including, for instance, exposures to specific foreign currencies.

(6) In its letter to the Council, the European Commission and the European Parliament of 29 March 2012, the European Systemic Risk Board (ESRB) expressed its view on the capacity of the macro-prudential authorities to implement macro-prudential instruments, as defined in the CRD IV/CRR. In particular, the ESRB underlined that macro-prudential authorities at both the Member State and Union level need discretion to tighten temporarily the calibration of a diverse range of Pillar I requirements and to require additional disclosures. These requirements include aggregate capital levels, liquidity requirements and limits to large exposures and to leverage, as well as capital requirements targeting individual sectors or addressing specific vulnerabilities across the different parts of banks' balance sheets.

(7) The CRD IV/CRR, while having mostly a micro-prudential focus, also envisages a set of macro-prudential instruments to be applied by the corresponding macro-prudential authority under certain conditions. This Recommendation suggests an indicative list of instruments, including but not limited to those envisaged in the CRD IV/CRR, that Member States could assign to macro-prudential authorities in order to pursue the identified intermediate objectives, while not restricting Member States in applying further instruments.

(8) Furthermore, macro-prudential authorities should develop an overall policy strategy on the application of macro-prudential instruments to foster decision-making, communication and accountability of macro-prudential policy.

(9) The effectiveness of macro-prudential policy also depends on the coordination between Member States on the application of macro-prudential instruments at national level. While macro-prudential policy will in general have substantial positive cross-border spillover effects, negative cross-border spillovers may occasionally arise. Macro-prudential authorities should assess the materiality of the net impact of such positive and negative spillovers, also to preserve the single market. The ESRB will consider potential cross-border spillovers of macro-prudential policy and, without prejudice to any relevant provisions of Union law, promote an appropriate coordination framework to address these issues.

(10) Over time, as authorities learn about the effectiveness of different macro-prudential instruments, the intermediate policy objectives and/or macro-prudential instruments may be revised, also taking into account potential new risks to financial stability. This

requires a periodic assessment of the adequacy of the established intermediate policy objectives and macro-prudential instruments.

(11) The current and proposed Union legislative framework is characterised by a complex and diverse set of macro-prudential provisions, which would greatly benefit from simplification and overall consistency in future reviews. Union institutions might also consider including macro-prudential instruments in the legislation affecting areas of the financial sector other than banking.

(12) In order to achieve a coherent application of macro-prudential instruments and to ensure macro-prudential oversight across the Union, the ESRB might consider in the future addressing recommendations to macro-prudential authorities to guide their application of macro-prudential instruments.

(13) Policymakers within and outside Europe are assessing the merits and drawbacks of an even larger set of possible instruments to prevent or mitigate systemic risks and legislative reforms to ring-fence risks in the financial system. The ESRB will continue to analyse the effectiveness and efficiency of other instruments being discussed as part of the macro-prudential policy framework.

(14) The proposal for a Council Regulation establishing a single supervisory mechanism (SSM),[5] as agreed by the Council on 12 December 2012, confers on the European Central Bank (ECB) the power to apply, if deemed necessary, higher requirements for capital buffers than applied by competent or designated authorities of participating Member States, and apply more stringent measures aimed at addressing systemic or macro-prudential risks, in accordance with the procedures set out in the framework of the CRD IV/CRR and in cases specifically set out in relevant Union law. The ESRB aims to cooperate with the ECB and the national competent authorities composing the SSM, as well as with the European Supervisory Authorities and other ESRB members, for the exercise of a coherent set of macro-prudential policies within the Union.

(15) This Recommendation is without prejudice to the monetary policy mandates and the oversight role for payment, clearing and settlement infrastructures of the central banks in the Union.

(16) ESRB Recommendations are published after informing the Council of the General Board's intention to do so and providing the Council with an opportunity to react,

HAS ADOPTED THIS RECOMMENDATION:

SECTION 1

RECOMMENDATIONS

Recommendation A — Definition of intermediate objectives

Macro-prudential authorities are recommended to:

1. define and pursue intermediate objectives of macro-prudential policy for their respective national financial system as a whole. These intermediate objectives should act as operational specifications to the ultimate objective of macro-prudential policy,

which is to contribute to the safeguard of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth. This implies, inter alia, releasing instruments that were previously used to tighten the macro-prudential policy stance;

2. these intermediate policy objectives should include:
   (a) to mitigate and prevent excessive credit growth and leverage;
   (b) to mitigate and prevent excessive maturity mismatch and market illiquidity;
   (c) to limit direct and indirect exposure concentrations;
   (d) to limit the systemic impact of misaligned incentives with a view to reducing moral hazard;
   (e) to strengthen the resilience of financial infrastructures;
3. assess the need for further intermediate objectives on the basis of underlying market failures and the specific structural characteristics of the country and/or Union financial system that could give rise to systemic risk.

Recommendation B — Selection of macro-prudential instruments

Member States are recommended to:

1. assess, in cooperation with the macro-prudential authorities, whether the macro-prudential instruments, currently under the direct control or recommendation powers of the latter, are sufficient to effectively and efficiently pursue the ultimate objective of macro-prudential policy, established under Recommendation ESRB/2011/3, as well as their intermediate objectives as defined in accordance with recommendation A. The assessment should take into consideration that macro-prudential authorities should have under their direct control or recommendation powers at least one macro-prudential instrument for each intermediate objective of macro-prudential policy, although more than one instrument may be needed;
2. if the assessment indicates that the available instruments are not sufficient, consider, in cooperation with the national macro-prudential authorities, additional macro-prudential instruments that should come under the direct control or recommendation powers of the latter. To this end, an indicative list of instruments is suggested for consideration in Table 1 below:

Table 1: *Indicative list of macro-prudential instruments*

1. Mitigate and prevent excessive credit growth and leverage

Counter-cyclical capital buffer

Sectoral capital requirements (including intra-financial system)

Macro-prudential leverage ratio

Loan-to-value requirements (LTV)

Loan-to-income/debt (service)-to-income requirements (LTI)

2. Mitigate and prevent excessive maturity mismatch and market illiquidity

Macro-prudential adjustment to liquidity ratio (e.g. liquidity coverage ratio)

Macro-prudential restrictions on funding sources (e.g. net stable funding ratio)

Macro-prudential unweighted limit to less stable funding (e.g. loan-to-deposit ratio)

Margin and haircut requirements

3. Limit direct and indirect exposure concentration

Large exposure restrictions

CCP clearing requirement

4. Limit the systemic impact of misaligned incentives with a view to reducing moral hazard

SIFI capital surcharges

5. Strengthen the resilience of financial infrastructures

Margin and haircut requirements on CCP clearing

Increased disclosure

Structural systemic risk buffer

3. following paragraphs 1 and 2, select any additional macro-prudential instruments, taking into account:
   (a) their effectiveness and efficiency to achieve each of the intermediate objectives in their respective jurisdictions, in accordance with recommendation A;
   (b) their capacity to address the structural and the cyclical dimension of systemic risks in their respective jurisdictions;
4. further to the selection of macro-prudential instruments, ensure that macro-prudential authorities are involved in the design and contribute to the national implementation of:
   (a) recovery and resolution regimes for banking and non-banking financial institutions;
   (b) deposit guarantee schemes;
5. establish a legal framework that permits the macro-prudential authorities to hold the direct control or recommendation powers over the macro-prudential instruments selected pursuant to this Recommendation.

Recommendation C — Policy strategy

Macro-prudential authorities are recommended to:

1. define a policy strategy that:

(a) links the ultimate objective of macro-prudential policy with the intermediate objectives and the macro-prudential instruments under their direct control or recommendation powers;
(b) establishes a sound framework for the application of instruments under their direct control or recommendation powers to pursue the ultimate and intermediate objectives of macro-prudential policy. This should include appropriate indicators to monitor the emergence of systemic risks and to guide decisions on the application, deactivation or calibration of time-varying macro-prudential instruments as well as an appropriate coordination mechanism with relevant authorities at the national level;
(c) fosters the transparency and accountability of macro-prudential policy;

2. conduct further analysis, on the basis of the practical application of macro-prudential instruments, to strengthen macro-prudential policy strategy, including on:
(a) instruments not established in Union legislation, for instance loan-to-value and loan-to-income requirements, and instruments to prevent or mitigate excessive maturity mismatches and market illiquidity;
(b) the transmission mechanism of instruments as well as on the identification of indicators that may inform decisions on their application, deactivation or calibration.

3. without prejudice to relevant provisions of Union legislation, inform the ESRB prior to the application of macro-prudential instruments at national level if significant cross-border effects on other Member States or the single market are to be expected.

Recommendation D — Periodical evaluation of intermediate objectives and instruments

Macro-prudential authorities are recommended to:

1. periodically assess the appropriateness of the intermediate objectives defined in accordance with recommendation A, in view of the experience gained in operating the macro-prudential policy framework, structural developments in the financial system and the emergence of new types of systemic risks;

2. periodically review the effectiveness and efficiency of the macro-prudential instruments selected in accordance with recommendation B, in achieving the ultimate and intermediate objectives of macro-prudential policy;

3. if warranted by the analysis under paragraph 1, adjust the set of intermediate objectives whenever necessary and, in particular, in case of the emergence of new risks to financial stability that cannot be sufficiently addressed within the existing framework;

4. inform the relevant authority in their Member State, so that the appropriate legal framework is established, in case new macro-prudential instruments are considered necessary;

5. report to the ESRB any change in the set of intermediate objectives and macro-prudential instruments that are under their direct control or recommendation powers and the underlying analysis supporting this change.

Recommendation E — Single market and Union legislation

The Commission is recommended, in the framework of forthcoming revisions of Union legislation, to:

1. take account of the need to establish a coherent set of macro-prudential instruments affecting the financial system, including all types of financial intermediaries, markets, products and market infrastructures;
2. ensure that adopted mechanisms permit Union institutions and Member States to interact efficiently and establish a sufficient level of flexibility for the macro-prudential authorities in order to activate those macro-prudential instruments whenever needed, while preserving the single market.

SECTION 2

IMPLEMENTATION

1. Interpretation

1. For the purposes of this Recommendation, the following definitions apply:
   (a) 'financial system' means financial system as defined in Regulation (EU) No 1092/2010;
   (b) 'macro-prudential authority' means national macro-prudential authorities with the objectives, arrangements, powers, accountability requirements and other characteristics set out in Recommendation ESRB/2011/3;
   (c) 'direct control' means real and effective capacity to impose and modify, where necessary to achieve an ultimate or intermediate objective, macro-prudential instruments over the financial institutions that are under the scope of action of the corresponding macro-prudential authority;
   (d) 'recommendation powers' means capacity to guide by means of recommendations the application of macro-prudential instruments, where necessary to achieve an ultimate or intermediate objective;
   (e) 'structural dimension of systemic risk' means the distribution of risks across the financial sector;
   (f) 'cyclical dimension of systemic risk' means the changes of systemic risk over time, originating from the tendency of financial institutions to assume excessive risks in the upswing and become excessively risk averse in the downswing;
   (g) 'effectiveness of the instrument' means the degree to which the instrument can address market failures and achieve the ultimate and intermediate objectives;
   (h) 'efficiency of the instrument' means the potential of the instrument to achieve the ultimate and intermediate objectives at minimum cost.
2. The Annex forms an integral part of this Recommendation. In the case of conflict between the main text and the Annex, the main text prevails.

2. Criteria for implementation

1. The following criteria apply to the implementation of this Recommendation:
   (a) regulatory arbitrage should be avoided;

(b) due regard should be paid to the principle of proportionality in the implementation, with reference to the different systemic significance of the financial institutions, to the different institutional systems and taking into account the objective and the content of each recommendation.

2. Addressees are requested to communicate the actions taken in response to this Recommendation, or adequately justify inaction. The reports should as a minimum contain:

   (a) information on the substance and timeline of the actions taken;

   (b) an assessment of the functioning of the actions taken, from the perspective of the objectives of this Recommendation;

   (c) detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Further information on the characteristics and particularities of each of the proposed intermediate objectives can be found in the Annex to this Recommendation, as well as an indicative list of macro-prudential instruments to pursue intermediate objectives. The Annex can assist the addressees in the selection of macro-prudential instruments as well as in the preparation of the policy strategy for their application.

3. Timeline for the follow-up

1. Addressees are requested to communicate the actions taken in response to this Recommendation, or adequately justify inaction, as specified in the following paragraphs:

   (a) recommendations A and B — by 31 December 2014, addressees are requested to communicate a report to the ESRB, the European Banking Authority (EBA) and the Council explaining the measures undertaken in order to comply with the content of recommendations A and B. Member States may report the measures undertaken with regard to recommendation B through their macro-prudential authorities;

   (b) recommendation C — by 31 December 2015, macro-prudential authorities are requested to communicate a report to the ESRB, the EBA and the Council explaining the measures undertaken in order to comply with the content of recommendation C(1). Recommendations C(2) and C(3) do not require a specific reporting deadline. Information provided by macro-prudential authorities to the ESRB under recommendation C(3) should be made available with reasonable notice;

   (c) recommendation D — recommendation D does not require a single reporting deadline. If there is a change in the intermediate objectives and instruments under the direct control or recommendation powers of macro-prudential authorities, they are requested to deliver a report thereon in good time to the ESRB, in line with recommendation D(5);

   (d) recommendation E — recommendation E does not require a specific reporting deadline. The Commission delivers a report to the ESRB on a biennial basis on the way in which macro-prudential policy objectives are included in the preparation of financial legislation. The first report should be delivered by 31 December 2014.

2. The General Board may extend the deadlines set forth in the previous paragraphs where legislative initiatives are necessary to comply with one or more recommendations.

4. Monitoring and assessment

1. The ESRB Secretariat:
   (a) assists the addressees, including by facilitating coordinated reporting, providing relevant templates and detailing where necessary the modalities and the timeline for the follow-up;
   (b) verifies the follow-up by the addressees, including by assisting them upon their request, and reports on the follow-up to the General Board via the Steering Committee.
2. The General Board assesses the actions and the justifications reported by the addressees and, where appropriate, decides whether this Recommendation has not been followed and if the addressees have failed to adequately justify their inaction.

SECTION 3

FINAL PROVISIONS

1. ESRB guidance on the application of the macro-prudential instruments

The ESRB may give guidance to the macro-prudential authorities on how to better implement and apply macro-prudential instruments, by means of recommendations pursuant to Article 16 of Regulation (EU) No 1092/2010. This may include indicators to guide the application of macro-prudential instruments.

2. Future reform of the macro-prudential toolkit

The ESRB may consider, in the future, expanding the indicative set of macro-prudential instruments contained in this Recommendation, by means of a recommendation pursuant to Article 16 of Regulation (EU) No 1092/2010.

Done in Frankfurt am Main, 4 April 2013.

The Chair of the ESRB

Mario DRAGHI

[1] OJ L 331, 15.12.2010, p. 1.

[2] OJ C 58, 24.2.2011, p. 4.

[3] OJ C 41, 14.2.2012, p. 1.

[4] Proposal for a directive of the European Parliament and of the Council on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate (COM(2011) 453 final) and Proposal for a regulation of the European Parliament and of the Council on prudential requirements for credit institutions and investment firms (COM(2011) 452 final).

[5] Proposal for a Council Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (COM(2012) 511 final).

ANNEX TO THE RECOMMENDATION ON INTERMEDIATE OBJECTIVES AND INSTRUMENTS OF MACRO-PRUDENTIAL POLICY

1. Introduction

Macro-prudential authorities have been, or are in the process of being, set up in most Union Member States. The next step towards making macro-prudential policy operational constitutes selecting effective and efficient macro-prudential policy instruments that will prevent or mitigate systemic risks in the financial system as a whole. This Annex presents a framework for this selection.

The ESRB Recommendation on the macro-prudential mandate of national authorities[1] refers to the identification of intermediate policy objectives as 'operational specifications of the ultimate objective'. Identifying intermediate objectives makes macro-prudential policy more operational, transparent and accountable, and provides an economic basis for instrument selection. The framework presented in this Annex is therefore based on a set of pre-identified and broad ranging intermediate objectives. It details how indicative instruments would help achieve those intermediate objectives and what indicators would signal a need for their activation or deactivation. Information on the legal base of individual instruments is also included. Forthcoming Union legislation is expected to provide a common legal base for some of the instruments.

In applying the framework, macro-prudential authorities should take risks to financial stability at the national level as a starting point. These risks may differ from country to country, given that the characteristics of financial systems and financial cycles vary across the Union. As a result, and in reflection of the fact that macro-prudential policy is at an early stage of development, different instruments may be selected in different Member States. At the same time, the fact that financial markets in the Union are highly integrated also calls for a coordinated approach. Coordination can strengthen the effectiveness and efficiency of macro-prudential policy by limiting the scope for arbitrage and leakage. It is also key for internalising positive and negative spillovers to the financial systems and economies of other Member States and protecting the functioning of the single market. While further Union-wide convergence in the macro-prudential toolkit can be expected over time, the application of the tools will need to be tailored to diverging financial cycles and heterogeneous risks.

The Annex is structured as follows:

- Section 2 identifies the intermediate objectives of macro-prudential policy and links them to the underlying market failures which are considered to be most relevant for macro-prudential policy,
- Section 3 suggests criteria for selecting macro-prudential instruments and provides an overview of intermediate objectives and indicative macro-prudential instruments,
- Attachment 1 provides an analysis of individual macro-prudential instruments; Attachment 2 discusses macro-prudential elements in insurance.

2. Identifying intermediate objectives

The ESRB Recommendation on the macro-prudential mandate of national authorities asks Member States to 'specify that the ultimate objective of macro-prudential policy is to contribute to the safeguard of the stability of the financial system as a whole, including by strengthening the resilience of the financial system and decreasing the build-up of systemic risks, thereby ensuring a sustainable contribution of the financial sector to economic growth'.

The relevant literature classifies systemic risk into two dimensions; structural and cyclical. The structural dimension concerns the distribution of risk across the financial system. The cyclical dimension is related to the tendency of banks to assume excessive risk in the upswing and become excessively risk averse in the downswing. While it is useful to take the structural and cyclical dimensions into account for the purpose of identifying the drivers of systemic risk and corresponding instruments, it is difficult to make a clear-cut distinction between the two dimensions given their close interlinkages.

Identifying intermediate objectives on the basis of specific market failures documented in the literature may allow for a clearer classification of macro-prudential instruments, ensure an economic base for the calibration and use of those instruments and foster the accountability of macro-prudential authorities. In practice, macro-prudential instruments are often already linked to intermediate objectives. The countercyclical buffer, for instance, aims to mitigate systemic risk arising from excessive credit growth. To develop a comprehensive view on intermediate objectives, this Annex uses the literature to identify the market failures relevant for macro-prudential policy and then maps them to individual objectives (see Table 1).[2]

The first intermediate objective is to mitigate and prevent excessive credit growth and leverage. Excessive credit growth has been identified as a key driver of financial crises, in which leverage acts as an amplification channel. The contrast between the impact of the collapse of the 'dot-com' bubble, which was largely equity funded, and the burst of the credit-fuelled sub-prime mortgage bubble illustrates the importance of leverage. In this respect, a distinction can be made between leverage within the financial system and that between financial institutions and real economy borrowers (i.e. by netting out intra-financial system claims). Macro-prudential policy could address excessive risk-taking in the upturn by tightening capital and collateral requirements. The buffers created in the upturn could be released in the downturn to absorb losses, alleviating the need for deleveraging and preventing bank runs, while supporting the extension of credit to sustain economic growth.

The second intermediate objective relates to excessive maturity mismatch (i.e. the extent to which long-term assets are funded with short-term liabilities). Experience shows that credit cycles coincide with increased reliance on short-term funding. This increases risks to financial stability owing to more illiquidity, fire sales and contagion. The focus of this intermediate objective is on the market liquidity of assets and reliance on short-term funds, as well as on information asymmetries that may link funding issues to asset prices. To address maturity mismatch, macro-prudential policy may require banks to finance their non-liquid assets with stable funding and to hold high-quality liquid assets to ensure refinancing of short-term funds. These measures aim to shield banks against market illiquidity and the related pressure of fire sales as well as against runs by depositors and other financial institutions.

Table 1: *Intermediate objectives of macro-prudential policy and related market failures*

Intermediate objective	**Underlying market failures**
Mitigate and prevent excessive credit growth and leverage	Credit crunch externalities: a sudden tightening of the conditions required to obtain a loan, resulting in a reduction of the availability of credit to the non-financial sector. Endogenous risk-taking: incentives that during a boom generate excessive risk-taking and, in the case of banks, a deterioration of lending standards. Explanations for this include signalling competence, market pressures to boost returns, or strategic interaction between institutions. Risk illusion: collective underestimation of risk related to short-term memory and the infrequency of financial crises. Bank runs: the withdrawal of wholesale or retail funding in case of actual or perceived insolvency. Interconnectedness externalities: contagious consequences of uncertainty about events at an institution or within a market.
Mitigate and prevent excessive maturity mismatch and market illiquidity	Fire sales externalities: arise from the forced sale of assets due to excessive asset and liability mismatches. This may lead to a liquidity spiral whereby falling asset prices induce further sales, deleveraging and spillovers to financial institutions with similar asset classes. Bank runs Market illiquidity: the drying-up of interbank or capital markets resulting from a general loss of confidence or very pessimistic expectations.
Limit direct and indirect exposure concentrations	Interconnectedness externalities Fire sales externalities: (here) arise from the forced sale of assets at a dislocated price given the distribution of exposures within the financial system.
Limit the systemic impact of misaligned incentives with a view to reducing moral hazard	Moral hazard and 'too big to fail': excessive risk-taking due to expectations of a bailout due to the perceived system relevance of an individual institution.
Strengthen the resilience of financial infrastructures	Interconnectedness externalities Fire sales externalities Risk illusion Incomplete contracts: compensation structures that provide incentives for risky behaviour.

The third intermediate objective is to limit direct and indirect exposure concentrations, taking into account their degree of riskiness. Direct concentration risk arises from large exposures to the non-financial sector (e.g. the housing market, sovereigns) as well as between financial sectors and/or financial entities. In addition, indirect exposures arise within the system owing to the interconnectedness of financial institutions and the contagious consequences of common exposures. Limiting large exposures can be achieved by establishing caps for specific financial sectors and (groups of) counterparties or by introducing circuit-breakers, such as CCPs, that help reduce the possible domino effect (e.g. contagion and fire sales) arising from an unexpected default or common exposures across financial institutions.

The fourth intermediate objective aims to limit the systemic impact of misaligned incentives with a view to reducing moral hazard. This involves strengthening the resilience of systemically important institutions, while counterbalancing the negative effects of an implicit government guarantee. Credible arrangements for orderly wind-down and resolution are also fundamental to address moral hazard. Finally, other measures such as asking market participants to ‘keep skin in the game’, or relating to management remuneration, could be applied.

The fifth intermediate objective is to strengthen the resilience of financial infrastructures. This can be achieved in two main ways: addressing externalities within the financial system’s infrastructure[3] and correcting the moral hazard effects that could arise from the institutional set-up. This could include legal systems, credit rating agencies, deposit guarantee schemes and market practices.

3. Selecting macro-prudential instruments

Having established the intermediate objectives of macro-prudential policy, the next step is to select instruments that can be used to pursue these objectives. Instruments should be selected on the basis of their effectiveness and efficiency in achieving intermediate and final objectives.

Effectiveness concerns the degree to which market failures can be addressed and intermediate and final objectives achieved. As a minimum, at least one effective instrument is needed for each intermediate objective (the Tinbergen rule). In practice, the use of multiple, complementary instruments can be justified, especially if it dampens the impact of regulatory arbitrage and uncertainty about the transmission mechanism.

A relevant consideration in this connection is how coordination can be used to avoid policy arbitrage: while some instruments are effective when applied at the country level (e.g. loan-to-value or loan-to-income limits), others would require an at least Union level of application (e.g. margin and haircut requirements, CCP clearing requirement). While most instruments would have some positive effects when applied at the country level, they would nevertheless benefit from Union-wide coordination. Coordination plays a role not only in enhancing the effectiveness of instruments, but also in internalising positive and negative spillovers to the financial systems of other Member States as well as protecting the proper functioning of the single market.

Efficiency relates to the achievement of objectives at minimum cost. A key issue is the trade-off between resilience and growth, since increasing resilience is not cost-free. This means that instruments that support long-term growth while containing systemic risk, and instruments that have a lower impact on other policy instruments, are preferable.

Table 2 contains a list of indicative macro-prudential instruments according to intermediate objectives.[4] In addition to the instruments included in Table 2, Member States may want to select instruments that best address specific risks to financial stability at the national level. Moreover, the framework of objectives and instruments should be subject to periodical evaluation and should reflect advances in the state of knowledge on macro-prudential policy as well as the emergence of new sources of systemic risk.

Table 2: *Intermediate objectives and indicative macro-prudential instruments*

1. Mitigate and prevent excessive credit growth and leverage

   Countercyclical capital buffer

   Sectoral capital requirements (including intra-financial system)

   Macro-prudential leverage ratio

   Loan-to-value requirements (LTV)

   Loan-to-income/debt (service)-to-income requirements (LTI)

2. Mitigate and prevent excessive maturity mismatch and market illiquidity

   Macro-prudential adjustment to liquidity ratio (e.g. liquidity coverage ratio)

   Macro-prudential restrictions on funding sources (e.g. net stable funding ratio)

   Macro-prudential unweighted limit to less stable funding (e.g. loan-to-deposit ratio)

   Margin and haircut requirements

3. Limit direct and indirect exposure concentration

   Large exposure restrictions

   CCP clearing requirement

4. Limit the systemic impact of misaligned incentives with a view to reducing moral hazard

   SIFI capital surcharges

5. Strengthen the resilience of financial infrastructures

   Margin and haircut requirements on CCP clearing

   Increased disclosure

   Structural systemic risk buffer

The limited use of macro-prudential instruments impedes a robust quantitative analysis of their effectiveness and efficiency. Evidence gathered from experience at the national level is, on the whole, limited. However, the analysis of the transmission and practical application of instruments presented in Attachment 1 indicates that knowledge is more advanced in respect of some instruments (e.g. capital-based instruments, large exposures limits, LTV/LTI limits) than others (e.g. margin and haircut requirements, the CCP clearing requirement). The different transmission channels and application scope of instruments support possible complementarities. For instance, capital-based instruments (affecting asset prices) and LTV/LTI limits (curtailing the quantity of financial services) could be used in parallel to limit excessive credit growth. Large exposure restrictions and CCP clearing requirements could also be applied contemporaneously, as they aim to contain counterparty risk across different types of transactions. In addition to the instruments shown in Table 2, macro-prudential authorities should be involved in the design and implementation of recovery and resolution plans and deposit insurance schemes, given their implications for the sound functioning of the financial system. While some of the specific tools listed in Table 2 have been designed with the banking sector in mind, they could be applied to other sectors: Attachment 2 discusses the potential role of macro-prudential policy in insurance.

Finally, with regard to the legal base of the instruments, the upcoming Capital Requirements Regulation and Capital Requirements Directive (CRR/CRD IV) for banks and large investment firms are expected to provide the flexibility to tighten the calibration of some of the instruments presented in Table 2 under certain conditions. This is in line with the ESRB letter on the principles for macro-prudential policies in Union legislation on the banking sector.[5] Instruments not enshrined in Union legislation[6] can be implemented at the national level if they have a proper legal base.[7] Still, the absence of detailed rules at Union level does not mean that Member States will be completely free to impose national rules, as some principles of Union law, such as the prohibition of introducing restrictions on the free movement of capital, could pose limits to national discretion.

Attachment 1

Macro-prudential instruments analysed by the ESRB

This attachment provides a summary of insights into the macro-prudential instruments analysed by the ESRB, grouped according to the intermediate objectives. It summarises how each instrument is defined, how it works (i.e. what we know about the transmission mechanism), the types of indicators that, alongside expert judgement, could guide a decision to activate or deactivate it, and how it can complement other instruments. While the conceptual analysis is already at an advanced stage with respect to several instruments, experience in using most of these instruments in the Union is limited (even though some instruments, such as LTV/LTI limits, have been applied before). Further analysis of their potential impact, indicators and scope for complementarity will be crucial.

1. Mitigate and prevent excessive credit growth and leverage

Countercyclical capital buffer (CCB)

The CCB is a capital add-on to the conservation buffer. The capital add-on can be raised or reduced in a countercyclical manner according to variations in systemic risk over time, in particular driven by the credit cycle. The purpose of the CCB is to protect the banking system against potential losses when excessive credit growth is associated with an increase in system-wide risk. The instrument has a direct effect on resilience: capital buffers will be built up during periods in which system-wide risks increase and can be used when those risks recede.

As a possible indirect effect, the CCB may help to counter the expansionary phase of the credit cycle by decreasing the supply of credit or increasing the cost of credit. The supply of credit can decline if banks increase capital ratios by decreasing risk-weighted assets. The cost of credit can rise due to a higher total cost of capital, which banks pass on to clients through higher lending rates. Both transmission channels can contribute to a decrease in credit volumes, which in turn helps to avoid the build-up of system-wide risk. Similarly, a release of the buffer may reduce the risk of the supply of credit being constrained by regulatory capital requirements when the credit cycle turns. Uncertainty regarding the indirect effect is higher than regarding the direct effect, and further research in this area is needed. The possible dampening of credit growth during the upturn of the credit cycle should be seen as a potential positive side-effect, rather than an objective of the CCB regime.

Policymakers setting the CCB may be guided in their judgment by the deviation of the credit-to-GDP ratio from its long-term trend as well as other relevant indicators. The empirical discussion has so far mostly focused on the properties of the credit-to-GDP gap. The gap represents the deviation of the credit-to-GDP ratio from its long-term trend, with a positive gap considered a proxy for excessive credit growth. Cross-country studies by the Bank for International Settlements underline the credit-to-GDP gap's good historical performance in signalling financial crises. At the same time, experiences at the national level show that it has not always given the right signal for activating the buffer or performed consistently well in signalling the release phase. An ESRB expert group has been set up to provide additional guidance for setting the buffer, in particular by conducting further cross-country analysis of other possible indicators for the Union Member States.

The CCB is provided for in the draft CRD IV and thus has to be implemented in national law. The draft CCB regime allows flexibility for macro-prudential authorities in setting the buffer subject to principles and guidance on indicators[8] and provides for a level of reciprocity in doing so.

Sectoral capital requirements (including requirements for intra-financial system exposures)

Aggregate capital requirements such as the countercyclical capital buffer may be a relatively blunt instrument when dealing with exuberance in particular sectors. In such cases, sectoral capital requirements[9] may be a more targeted tool if systemic risk is not adequately captured by micro-prudential requirements. They may be applied by (a) scaling micro-prudential capital requirements associated with a particular sector or asset class by a multiplier or (b) applying a capital surcharge or add-on to a bank's risk-weighted exposures to a particular sector or asset class. Risk weight floors could also be set.

The transmission mechanism is similar to that of the CCB, with two differences. First, an increase in capital requirements for a particular sector changes relative prices, thereby reducing lending (growth) to the targeted sector as the relative marginal funding costs for this sector would tend to rise. Second, banks might be more likely to reduce exposure than to raise equity if a sector has been singled out as particularly risky.

This instrument should be brought into play when systemic risk is seen to build up within a particular sector or asset class. One potential indicator of such a build-up could be credit data by sector, which could be calculated as sectoral credit-to-GDP gaps. Complementary data, such as mortgage volumes or real estate prices for the real estate sector, could also be significant for signalling the build-up of risk.

The draft CRR foresees the possibility to adjust capital requirements for residential and commercial property as well as intra-financial system exposures for macro-prudential or systemic risk reasons, subject to a procedure at Union level.

Macro-prudential leverage ratio

The leverage ratio is defined as the ratio of a bank's equity to total (non-risk-adjusted) assets. To serve macro-prudential purposes, a leverage ratio requirement could be applied to all banks as an add-on and possibly also in a time varying manner. In particular, where macro-prudential risk-weighted capital requirements are applied in a time varying manner, the leverage ratio requirement could also be changed over time, to maintain its function as a backstop. As a macro-prudential instrument, the leverage ratio requirement has the advantage of being relatively simple and transparent.

The transmission mechanism for the leverage ratio requirement is similar to that of risk-weighted capital requirements. Where the leverage ratio is more restrictive than risk-weighted requirements, banks could raise equity, retain earnings or reduce assets to meet the higher requirements.[10] The price of credit would be likely to increase, and the quantity of credit extended might decline.[11]

The leverage ratio is sometimes considered an indicator of systemic risk. Indeed, a BCBS study found that the leverage ratio enabled banks that required public sector support during the recent financial crisis to be identified.[12] In addition, other indicators, potentially also relevant for the countercyclical capital buffer, could be used to guide decisions on the leverage ratio.

Once it has been adopted as a detailed binding instrument after an observation period in accordance with the forthcoming CRR, the tightening of the leverage ratio requirement for macro-prudential purposes may be allowed subject to a procedure at Union level. Before its harmonisation across the Union, its use may be envisaged at the national level.

Loan-to-value (LTV) and loan-to-income/debt (service)-to-income (LTI) requirements

The LTV requirement is a limit on the value of a loan relative to the underlying collateral (e.g. residential property); the LTI requirement is a limit on debt servicing costs relative to disposable income. The reference point differs from the instruments discussed until now: it is the contract between the client and the financial institution, rather than the institution itself.

The macro-prudential purpose of LTV and LTI limits is to dampen the credit cycle and to increase the resilience of financial institutions. The effect on the amplitude of the credit cycle results from the mitigating impact of more stringent LTV ratios on the ‘financial accelerator’ mechanism: when a positive income shock leads to an increase in housing prices, the increase in borrowing is expected to be lower in countries with lower LTV ratios.[13] Furthermore, lower LTV limits can increase the resilience of the banking system via a lower loss given default, while lower LTI limits can reduce the probability of default. LTV and LTI limits are generally seen as complementary instruments. Since income is more stable than housing prices, LTI limits may become more restrictive in times of rising housing prices. Although in practice LTV and LTI limits have typically been used as static limits, they can also be used in a time-varying way. Expectations may, however, play a destabilising role. If households expect a tightening in caps, they might rush to get loans with high LTV/LTI ratios.

Although LTV or LTI limits have been applied in several EU countries, they are not applied in a harmonised way across the Union. Given the lack of harmonised definitions or guidelines for these instruments at the Union level, a more thorough assessment by the ESRB could be useful with a view to providing guidance to macro-prudential authorities.

Complementarity

The CCB, sectoral capital requirements and leverage ratio requirement complement each other in their focus (ranging from broad to narrow), risk sensitivity and implementation (some addressing cyclical, others structural, manifestations of systemic risk). LTV/LTI limits are sometimes seen as substitutes to sectoral capital requirements for the housing market. They can, however, also be seen as complementary to capital-based tools for a number of reasons. First, while capital based tools may have an impact mainly on the supply of credit, LTV/LTI limits mainly affect the demand side (i.e. the banks' loan customers). Second, if risk is not adequately captured, for example by sectoral capital requirements for the housing market, LTV/LTI limits can act as necessary backstops. Finally, the effectiveness of capital based instruments could be affected by the need for coordination between Member States; this is not the case for LTV/LTI, as their reference point is the contract between the client and the financial institution, rather than the institution itself. Therefore, they are less prone to regulatory arbitrage that shifts business abroad or to the shadow banking system.[14]

2. Mitigate and prevent excessive maturity mismatch and market illiquidity

Macro-prudential adjustment to liquidity ratio (e.g. liquidity coverage ratio – LCR) and macro-prudential restrictions on funding sources (e.g. net stable funding ratio – NSFR)

The LCR (ratio of high-quality liquid assets to total net cash outflows over the next 30 days) measures banks' ability to withstand a short predefined period of liquidity stress and ensures that banks' liquid assets can counterbalance a potential short stressed outflow of liquidity; its definition has been agreed on by the Basel committee. The NSFR (ratio of available to required amount of stable funding) seeks to put a floor on the amount of long-term funding banks hold against less liquid assets, but the Basel committee have yet to agree on a precise definition. Macro-prudential policy action could take the form of an add-on or other macro-prudential adjustment to the regulatory levels for both instruments; it could also be possible to target only specific groups of banks (e.g. systemically important banks) rather than the entire banking sector.

The primary intermediate objective of these instruments is to mitigate excessive maturity mismatch and funding risk.[15] Moreover, they may increase the system's resilience to excessive credit and leverage.[16] Banks can meet these liquidity requirements by increasing funding maturity or investing in liquid assets (or both). To avoid pro-cyclicality, banks should be allowed to use their buffers in times of liquidity stress.

Indicators for tightening the requirements could include data on banks' balance sheets, economic indicators and market (equity, CDS) data. Indicators such as strong changes in interbank volumes and rates, use of ECB facilities, the use and availability of collateral and signals of bank runs (e.g. urgent withdrawals or payments) could help determine when relaxing limits may be appropriate.[17] Some indicators may overlap with those related to time-varying capital-based tools.

The LCR and the NSFR are expected to be introduced as detailed binding requirements by the CRR only after respective observation periods. Before the harmonisation of the instruments at the Union level, Member States are expected to have the possibility to apply national liquidity requirements or prudential charges taking into account a number of considerations, including systemic liquidity risk. In addition, the draft Union legislation foresees the possibility to adjust liquidity instruments for macro-prudential purposes subject to a procedure at Union level.

Macro-prudential unweighted limit to less stable funding (e.g. loan-to-deposit ratio)

In some countries, an unweighted liquidity limit to less stable funding such as the loan-to-deposit (LTD) ratio has been applied with a view to limiting excessive dependence on less stable funding sources. Customer deposits are generally seen as a stable source of funding, meaning that the LTD ratio (or extended versions of it) can be used to limit excessive structural dependence on less stable market funding. However, the instrument does not take into account the maturity structure of market funding, and its impact varies across banks with different business models. Core funding ratios or wholesale funding ratios are related measures.

The LTD requirement can be met by either reducing lending or increasing deposits. The experience of the last crisis has shown that in a downturn deposits gain relative to loans in some cases, as the former remain stable or even increase (due to shifts from other types of savings) while the demand for the latter decreases due to a decline in economic activity. Thus, the LTD ratio may follow the cycle, making a related requirement restrictive in booms and non-restrictive in downturns. There may be incentives for regulatory arbitrage if loans and deposits are not properly defined; banks may set up new financing structures with debt securities to avoid inclusion in the numerator.

Where necessary, the LTD ratio can be used to address excessive leverage or credit (as signalled by the credit-to-GDP ratio or its development) and enhance the structural liquidity position of banks.

Margin and haircut requirements

Haircuts and initial margins determine the level of collateralisation in secured financing and derivatives transactions. Broadly speaking, in secured financing transactions the level of collateralisation is determined by the haircut applied to securities received as collateral. In derivatives transactions, the level of collateralisation depends primarily on the initial margin requirement (which protects a market participant against potential changes in the value of their position, in the event that their counterparty defaults), as well as on the haircut applied to securities posted to meet that requirement. Haircuts and margins imposed by supervisory authorities can curb financing booms and dampen the contraction of secured funding in downturns (i.e. reduce the pro-cyclicality of market liquidity, potentially mitigating liquidity hoarding and fire sales). They can also help to limit excessive credit growth and leverage.

Employing a through-the-cycle approach (using long historical data sets that include stressed and stable market conditions) will mean that margins and haircuts are less dependent on current market conditions. This can be complemented by a discretionary countercyclical add-on to regulate secured funding when necessary, ensuring a more realistic pricing of risks and a reduction of exuberance. However, a tightening of requirements, particularly at the height of the financial cycle, can destabilise markets as this imposes strains on funding. As a result, asset prices may fall, which increases haircuts and margins and can lead to a downward spiral.[18]

Current legislation does not provide a role for macro-prudential authorities in this area. For over-the-counter derivatives, this might be considered in the first review of the European Market Infrastructure Regulation (EMIR). Further, margins and haircuts, being instruments that target market transactions, would be subject to regulatory arbitrage and would benefit from global application.

Complementarity

Possible complementarities can be envisaged between the LCR, NSFR and LTD requirements, owing largely to differences in their maturity, scope and risk sensitivity. The liquidity instruments can also complement solvency instruments such as the CCB in reducing leverage and increasing resilience. Furthermore, margin and haircut requirements complement the bank-specific measures (especially the NSFR and LTD) as they could have an impact on aggregate market liquidity and the stability of funding.

3. Limit direct and indirect exposure concentrations

Large exposure restrictions

The CRD defines a large exposure as an 'exposure to a client or group of connected clients … where its value is equal to or exceeds 10 % of its own funds'. Credit institutions and investment firms cannot incur an exposure of more than 25 % of their own funds (capital) to any one client or group of clients. The CRD also foresees discretion for Member States in handling certain types of exposures (e.g. to systemically relevant sectors) in view of their riskiness, which could provide scope for macro-prudential intervention. Large exposure restrictions can mitigate concentration risk, reduce counterparty risk and possible contagion (also to the shadow banking sector).[19] They also limit the sensitivity of financial institutions to common or sectoral shocks.

By setting limits on exposures to specific counterparties or sectors (e.g. real estate or other financial institutions), the large exposure restriction directly promotes the distribution of risk through the system.[20] It also improves the depth of the interbank market and diversifies funding for financial and non-financial institutions. Moreover, exposure limits reduce the potential impact of a single counterparty default. As with most macro-prudential instruments, pro-cyclicality can arise: an increase in capital during booms can increase the exposure limit, while a capital reduction during downturns can make the limit more restrictive. Moreover, the restriction can inhibit growth or prevent institutions from taking advantage of expertise in certain sectors.

Under the CRD, financial institutions are required to report exposures exceeding 10 % of capital. Network analysis can use this information to determine whether macro-prudential restrictions are appropriate. If necessary, the reporting threshold can be lowered to incorporate systemically relevant global institutions with a large capital base. The draft CRR foresees the possibility of tightening large exposure requirements at the national level for macro-prudential purposes subject to a procedure at Union level.

CCP clearing requirement

Regulators can require certain transactions by financial institutions to be cleared through central counterparties (CCPs). Replacing a network of bilateral exposures with a structure in which each participant has a single exposure towards the CCP can redistribute counterparty risk and centralise risk control and default management. This can help contain spillovers and maintain market stability in the interbank market.

However, this measure also involves transaction costs and raises the potential for regulatory arbitrage, for example by moving towards transactions that are not subject to CCP clearing. Furthermore, the systemic importance of CCPs increases, since they concentrate counterparty risk, which may lead to excessive market power, moral hazard or systemic risk (from defaults).[21] Moreover, the risk management and risk absorption capacity of CCPs are largely untested, especially at the possibly much higher transaction level. Strict regulation of CCPs will therefore be required, including on the development of suitable resolution and recovery plans for CCPs. The selection of products requiring CCP clearing must also be made with care.

Suitable selection indicators to decide which contracts should be subject to the CCP clearing requirement include standardisation, liquidity, complexity and risk characteristics, as well as the potential reduction of systemic risk and the possibility of international harmonisation.

There are global efforts under way to mandate central clearing of standardised over-the-counter derivatives; in the Union, this will be introduced under EMIR. Still, further research on the effects of its implementation is needed before it can be included in the macro-prudential toolkit. Moreover, to be effective the requirement must be implemented on a Union-wide, if not global, basis.

Complementarity

The two aforementioned measures are complementary, as they can mitigate the systemic effects of counterparty risk across different types of transactions. While the large exposure restriction reduces the concentration of risk in one counterparty or sector, the CCP clearing requirement reduces the propagation of counterparty defaults by managing the risk in one place where it can be contained. Tightening large exposures restrictions can also work alongside sectoral capital requirements or LTV limits and structural buffers to strengthen financial structure. Finally, central clearing should be supplemented with margin and haircut requirements for CCPs to make them resilient to counterparty risk; these should be aligned with the requirements for non-centrally cleared transactions.

4. Limit the systemic impact of misaligned incentives with a view to reducing moral hazard

SIFI capital surcharges

Systemically Important Financial Institutions (SIFIs) could be subject to an additional capital buffer requirement. The objective of the surcharge is to enhance SIFI loss-absorption capacity. This reduces both the probability of stress events and their potential impact. The capital buffer could be applied to systemically important banks, but could be extended to other systemically important institutions.

The buffer can also correct potential funding subsidies for SIFIs stemming from an implicit government guarantee. As such, a level playing field for small and medium-sized (non-systemic) banks is maintained and SIFIs are better equipped to withstand shocks. On the negative side, the surcharge can push activities into the shadow banking sector and make the SIFI status explicit, thus activating the implicit funding subsidy and distorting competition. Overall, the Macroeconomic Assessment Group has concluded that the financial stability benefits of the SIFI surcharge outweigh the economic costs (expressed as a temporary reduction in GDP).

The systemic nature of banks (and other institutions) is determined by comparing indicators in the following categories: size, interconnectedness, substitutability and complexity. For banks, the requirements are planned to be introduced in parallel with the Basel III capital conservation and countercyclical buffers. SIFI capital surcharges are expected to be introduced at Union level in some form in the forthcoming CRD IV.

Recovery and resolution regimes

Regulatory authorities need tools to prevent financial crises and mitigate their effects if they nevertheless arise. Prevention and mitigation require recovery plans (drawn up by banks) and resolution plans (drawn up by the authorities). Early intervention powers for authorities allow them to act to seek to prevent the failure of a bank should recovery actions taken by the latter prove insufficient. Resolution powers enable them to assume control of a failing bank if preventive measures taken by the bank or the authorities have failed. This regime, as proposed in the draft Bank Recovery and Resolution Directive (BRRD), aims to minimise the systemic impact of bank distress and failure by ensuring the continuity of banks' functions, containing the impact of failures and minimising losses to taxpayers by allocating them to stakeholders (e.g. through bail-in or leaving them behind in an administration procedure whilst critical functions are transferred to a bridge bank or third-party purchaser). From a macro-prudential perspective, the BRRD helps minimise the systemic implications of exposure concentrations, improve understanding of connectedness and mitigate the impact of crisis externalities.

The transmission works through two main channels. First, it limits moral hazard in systemically important banks and the implicit subsidy they may enjoy by helping to ensure that creditors, rather than third parties such as national governments, bear losses in the event of a bank's failure. Second, effective resolution mitigates the impact of direct or indirect spillovers from an individual bank's failure (contagion). It can also bolster public confidence in financial institutions. The removal of implicit state guarantees could be expected to cause bank funding costs to rise and sovereign funding costs to fall, by roughly equal amounts. However, bank funding costs would be much more elevated if the only alternative to a government bailout were a disorderly and potentially prolonged and costly bankruptcy process. So, overall effective resolution regimes should help to improve access to credit by the real economy in the medium to long term.

Effectively dealing with banks that fail could be undermined by a lack of resolution powers and tools, insufficient credibility in applying them and too little temporary funding to provide the necessary liquidity to support resolution measures. These deficiencies should be taken into consideration and avoided in setting up resolution regimes.

Complementarity

The SIFI surcharge and resolution regimes complement each other in reducing implicit bailout subsidies, competitive distortions and the systemic impact of defaults. The surcharge can act as an ex ante complement to ex post resolution regimes.[22] The SIFI surcharge should be seen as part of a package of capital charges including the capital conservation, countercyclical and structural buffers.

5. Strengthen the resilience of financial infrastructure

Deposit guarantee schemes (DGSs)

In case of bank failure, a DGS acts as a safety net for bank account holders by reimbursing them up to a certain coverage amount. A DGS thus strengthens the resilience of financial infrastructures by helping to avoid bank runs and improving confidence in the financial system. It also safeguards the stability of payment systems, as deposits are an integral part of these.

Since bank deposits are guaranteed, depositors have fewer incentives to withdraw their deposits in case of bank distress; this avoids bank runs and their systemic implications. More generally, by acting as a safety net, DGSs improve the efficiency of the financial system by increasing confidence. The effectiveness of DGSs depends on their credibility, which is related to adequate funding arrangements. Ex ante funding of DGSs, based on bank risk, is countercyclical and can thus have direct macro-prudential stability effects.[23]

When coverage is very high, unlimited or ill-defined, or when funding is not risk-based, adverse incentive effects can arise; depositors may not monitor banks closely, leading to moral hazard. Additionally, unfunded DGSs can require payments from banks in downturns, leading to negative pro-cyclical effects. Finally, a lack of cross-border coordination can lead to unwelcome competition among DGSs. It is thus important that the Union continue with its effort to harmonise the structure of DGSs, also in the context of the draft recast of the DGS directive proposed by the Commission. Macro-prudential authorities should closely follow and have a say in the design and implementation of DGSs, in particular with regard to coverage and funding arrangements.

Margin and haircut requirements on CCP clearing

As with bilaterally cleared trades, the margin and haircut requirements of centrally cleared trades can have systemic implications. When setting appropriate haircuts and initial margins, CCPs should take into account market liquidity, pro-cyclical effects and systemic risks. In particular, the look-back period (time horizon to calculate historical volatility) should be set to avoid excessive pro-cyclicality. This limits disruptive changes in margin requirements and establishes transparent and predictable procedures for adjusting the requirements. Furthermore, a CCP should limit dependence on commercial credit ratings in calculating margins and haircuts. Both these requirements are captured in the draft technical standards that support EMIR.

In applying these requirements, CCPs must remain flexible and responsible, balancing the need to self-protect with the desire to ensure systemic stability. As the role and systemic importance of CCPs in the financial system is likely to increase in the future, the appropriate regulation of CCPs will become more important, and this is recognised for micro-prudential purposes in EMIR. Although EMIR does not yet provide a role for macro-prudential authorities in setting CCP margin requirements, this can be reconsidered during the first scheduled reviews.

Increased disclosure

Alongside disclosure for micro-prudential reasons, macro-prudential authorities could introduce additional disclosure requirements in view of structural or cyclical systemic risk. Transparency enables market forces to act as a disciplining mechanism on individual institutions' behaviour and enables more accurate pricing of risk within the financial system. Disclosure also has the potential to limit the amplification of stress in the financial system by reducing uncertainty about the size and location of certain exposures and system interlinkages.

Where clearer information is disclosed, risk awareness can be promoted and market discipline can be enhanced. This enhances market confidence and safeguards financial stability, thereby avoiding market breakdowns such as that of the interbank market after the collapse of Lehman Brothers. On the other hand, macro- and micro-prudential disclosure requirements may not always be in line. An aggregate improvement in disclosure may, for instance, reveal ailing banks, leading to individual failures without systemic effects. In general, the available empirical evidence supports enhanced disclosure.[24] In terms of legal implementation, the draft CRR foresees the possibility of enhancing disclosure requirements at the national level for macro-prudential purposes subject to a procedure at Union level.

Structural systemic risk buffer

The upcoming CRD IV is expected to introduce a systemic risk buffer to prevent and mitigate structural risk (hereafter 'the structural buffer'), subject to a procedure at Union level. The structural buffer can be used to strengthen the resilience of the banking system, or its subsets, to possible shocks stemming from structural systemic risk. This risk can arise from changes in legislation or accounting standards, cyclical spillovers from the real economy, a large financial system relative to GDP or financial innovation that increases complexity.

The structural buffer increases resilience through an increase in loss-absorption capacity. It shifts more downside risk to equity holders and increases solvency, thereby reducing the likelihood of structural risk materialising. Possible negative effects of the structural buffer include a loss of the cross-border level playing field, a decline in banks' voluntary capital and leakages to the shadow banking system. However, higher structural buffers also restrict leverage and risk-taking.

It is difficult to pinpoint indicators for applying the structural buffer; the aforementioned structural vulnerabilities can serve as a guide. When experience in the application of the structural buffer has been gained, an analysis of its capacity to address structural risks should be carried out.

Complementarity

As the aforementioned measures aim to increase the overall resilience of financial infrastructure, they interact with many other instruments. For instance, DGSs could complement liquidity instruments by ensuring a stable deposit funding base. They could also complement the structural buffer (and other capital-based instruments) as they reduce the impact of failures. Margin and haircut requirements for CCPs and for non-centrally cleared transactions should be aligned to ensure a level-playing field. Moreover, margin and haircut requirements (for both CCPs and other transactions) could complement leverage ratios by reducing excessive leverage. As disclosure reduces information asymmetries, it has the potential to improve market confidence and increase market liquidity.

The effect of the structural buffer can interact with the effects of other capital-based instruments such as the countercyclical buffers. Coordination is therefore necessary in deciding on the appropriate aggregate level of the capital requirements.

Attachment 2

Intermediate objectives of macro-prudential policy in insurance

Macro-prudential considerations in the field of insurance are still at the inception stage. There are a number of reasons for this:

- most insurance companies emerged from the crisis relatively unscathed,
- the low systemic risk of traditional insurance activities, which are characterised by a predominantly liability-driven investment strategy, a high degree of substitutability, and a low likelihood of runs,
- the lack of an international standard for insurance supervision, although the introduction of the Solvency II framework will set a common standard for the Union.

Still, some insurance companies have expanded their operations to activities that are more likely to contribute to or amplify systemic risk. In particular, non-traditional insurance activities and non-insurance activities could result in correlated common exposures to the financial and business cycle. This is the case, for example, of credit default swaps (CDS) transactions for non-hedging purposes.[25] Non-traditional insurance activities could have wider implications for the financial system and the economy, as in the case of financial guarantees used to improve the rating of complex structured products prior to the crisis. Non-insurance activities (e.g. securities lending) and group structures (e.g. 'bancassurance') could also increase interconnectedness in the financial system. These types of activities are also perceived as having a higher systemic relevance by the International Association of Insurance Supervisors (IAIS) which uses them to identify Global Systemically Important Insurers.

Imposing measures upon non-traditional insurance and non-insurance activities as defined by IAIS is challenging. This is because there is no clear-cut separation and the same activities are often classified differently by the supervisors (e.g. third-party asset management). Therefore, a 'substance over form' analysis is necessary to determine the risk of a specific product or service.

In addition to the abovementioned structural considerations, systemic risk in the insurance sector has a cyclical dimension, since insurers are important investors and may take on more or less risky assets. In the Union, the Solvency II framework introduces market-consistent valuation of insurers' balance sheets. This entails marking the asset side to market, while valuing liabilities by discounting cash flows using risk-free interest rates. This leads to volatile balance sheets and capital levels for insurers that sell long term products. This has the potential of exacerbating pro-cyclical dynamics within the sector and across the financial system. During the upturn, exuberance in risky asset prices can expand market-consistent capital, relative to regulatory capital requirements, while contracting it in the downturn. This could generate capacity for excessive risk-taking in the upturn and pressure to dispose of risky assets in the downturn. Therefore, Solvency II currently contains countercyclical mechanisms, including the equity dampener for equity risks, the possibility of an extended recovery period, and the extrapolation of the risk-free interest-rate curve to a fixed ultimate forward rate. Moreover, discussions are taking place about the inclusion of the 'countercyclical premium' and 'matching adjustments', which both aim to correct capital levels taking excess volatility into account. Without careful design, some of these proposed mechanisms could give rise to unintended consequences for both insurers and the system as a whole. It is important that such mechanisms are transparent and induce, in upturns, the build-up of buffers which can be used in downturns.

Overall, it can be argued that the structural dimension of systemic risk mainly concerns non-traditional and non-insurance activities. These are the activities that are most likely to distribute risk across the financial system and, as such, can be framed in terms of the intermediate objectives and instruments set out in this document. To the extent that these activities constitute relevant criteria for identifying Systemically Important Insurers, they would fall under the intermediate objective of limiting the systemic impact of misaligned incentives with a view to reducing moral hazard. It should be noted, however, that this scenario has been less frequent in the case of insurers than in the case of banks. The structural dimension is also linked to the interconnectedness of insurance and other financial sector entities and the resulting potential for risk contagion. This falls under the intermediate objective of limiting direct and indirect exposure concentrations. Finally, the cyclical dimension is closely linked to endogenous risk taking and fire sales.

[1] ESRB/2011/03 (http://www.esrb.europa.eu/pub/pdf/recommendations/2011/ESRB_2011_3.en.pdf).

[2] The literature is far too extensive to be summarised here. See, for example, Brunnermeier, M., Crockett, A., Goodhart, C., Persaud, A. and Shin, H. (2009), 'The Fundamental Principles of Financial Regulation', Geneva Report on the World Economy 11, ICBM, Geneva and CEPR, London; Gorton, G. and He, P. (2008), 'Bank Credit Cycles', Review of Economic Studies 75(4), pp. 1181-1214, Blackwell Publishing; Bank of England (2009), 'The Role of Macro-prudential Policy', A Discussion Paper; Bank of England (2011), 'Instruments of macroprudential policy', A Discussion Paper; Hellwig, M. (1995), 'Systemic aspects of risk management in banking and finance', Schweizerische Zeitschrift für Volkswirtschaft und Statistik, 131, pp. 723-737; Acharya, V. V. (2009), 'A Theory of Systemic Risk and Design of Prudential Bank Regulation', Journal of Financial Stability, 5(3), pp. 224-255; Hanson, S., Kashyap, A. and Stein, J. (2011), 'A Macro-prudential Approach to Financial Regulation', Journal of Economic Perspectives 25, pp. 3-28; Longworth, D. (2011), 'A Survey of Macro-prudential Policy Issues', Mimeo, Carleton University.

[3] The oversight role of central banks is usually considered an integral element of their function in ensuring financial stability. Irrespective of institutional arrangements, the macro-prudential authority should work in close cooperation with the authority in charge of infrastructure oversight to achieve this intermediate objective.

[4] The instruments are selected from a 'long list' of all potential instruments, on the basis of top-down 'gap' analysis and surveys among members of the ESRB Instruments Working Group, according to the above mentioned selection criteria.

[5] ESRB, Principles for macro-prudential policies in EU legislation on the banking sector, 2 April 2012 (http://www.esrb.europa.eu/news/pr/2012/html/pr120402.en.html).

[6] Some instruments not included in Table 2 are envisaged in EU legislation (e.g. the ban on short-selling).

[7] An ESRB stocktake for instruments not enshrined in EU law indicates that: LTV limits are available in the national prudential framework of 16 Member States, but only 7 can use them for macro-prudential purposes; LTI limits are available in the national prudential framework of 12 Member States, but only 2 can use them for macro-prudential purposes; an unweighted liquidity ratio is available in the national prudential framework of 3 Member States and can also be used for macro-prudential purposes; recovery and resolution regimes/plans are available in the national prudential framework of 11 Member States, 8 of which can use them for macro-prudential purposes. In 6 Member States, some steps have been taken to implement such a regime. In 4 of these countries, recovery or resolution plans are expected to be available for macro-prudential purposes.

[8] The principle of 'constrained discretion' involves ESRB guidance, setting a benchmark against a macro variable, communication and transparency.

[9] Sectoral capital requirements cover both risk weights and the calibration of Internal Ratings Based models for specific sectors or asset classes.

[10] See the discussion of the transmission mechanism for risk-weighted capital tools.

[11] The reverse should hold for a loosening in requirements. Market pressures might, however, imply that banks cannot lower their leverage (or risk-weighted capital) ratios by the full amount, potentially reducing the effectiveness of the tools in a downturn.

[12] See BCBS (2010), 'Calibrating regulatory minimum capital requirements and capital buffers: a top-down approach'. In addition, a number of other studies have found that leverage is a powerful indicator of systemic risk – for example Barrell, Davis and Liadze (2010), 'Calibrating Macro-prudential Policy'; Kato, Kobayashi and Sita (2010), 'Calibrating the level of capital: the way we see it'; Adrian and Shin (2010), 'Liquidity and Leverage'; and Papanikolaou and Wolff (2010), 'Leverage and risk in US commercial banking in the light of the current financial crisis'.

[13] Almeida, H., Campello, M. and Liu, C. (2006), 'The financial accelerator: evidence from international housing markets', Review of Finance 10, pp. 1-32.

[14] Still, LTV limits can be subject to their own forms of circumventing, by resorting to uncollateralised loans. Insofar as banks have discretion to judge the value of the collateral (e.g. when part of the loan is used for improving the quality of the house) they might have incentives to give more optimistic valuations in order to mitigate the impact of a limitation in the LTV.

[15] Evidence on the effectiveness of liquidity-based macro-prudential instruments is scarce. A few papers show that a countercyclical application of LCR or NSFR is beneficial in dealing with liquidity stress. See, for example, Giordana and Schumacher, 'The impact of the Basel III liquidity regulations on the bank lending channel: A Luxembourg case study', Working Paper No 61, June 2011; Bloor, Craigie and Munro, 'The macroeconomic effects of a stable funding requirement', Reserve Bank of New Zealand Discussion Paper Series DP 2012/05, August 2012; or Van den End and Kruidhof, 'Modelling the liquidity ratio as a macro-prudential instrument', DNB Working Paper No 342, April 2012.

[16] See CGFS Working group on the Selection and Application of Macro-prudential instruments (SAM), 'Transmission Mechanisms of Macro-prudential Instruments', interim report by Workstream 4, March 2012.

[17] Heijmans and Heuver, 'Is this bank ill? The diagnosis of doctor Target 2', DNB Working Paper No 316, August 2011.

[18] See, for example, Brunnermeier, M. and Pedersen, L. (2009), 'Market Liquidity and Funding Liquidity', Review of Financial Studies, Society for Financial Studies, Vol. 22(6), pp. 2201-2238, and Gorton, G. and Metrick, A. (2012), 'Securitized banking and the run on repo', Journal of Financial Economics, Elsevier, Vol. 104(3), pp. 425-451.

[19] Specific empirical evidence is scarce, but historical experience shows that concentration in certain sectors (often real estate) is at the epicentre of financial instability.

[20] Note that exposures to sovereign debt are currently exempted from large exposures restrictions.

[21] For more discussion of these adverse effects see, for example, Pirrong, C. (2011), 'The economics of central clearing: theory and practice', International Swaps and Derivatives Association Discussion Paper No 1 and Singh, M. (2011), 'Making OTC Derivatives Safe – A Fresh Look', IMF Working Paper 11/66.

[22] See, for example, Claessens, Herring and Schoenmaker (2010), 'A Safer World Financial System: Improving the Resolution of Systemic Institutions', Geneva Reports on the World Economy (London, UK: CEPR), and Claessens et al., 'Crisis Management and Resolution: Early Lessons from the Financial Crisis', IMF Staff Discussion Note 11/05, March 9, 2011.

[23] See, for example, Acharya, Santos and Yorulmazer: 'Systemic Risk and Deposit Insurance Premiums', FRBNY Economic Policy Review, August 2010.

[24] Hirtle, B. (2007), 'Public disclosure, risk, and performance at bank holding companies', Staff Report No 293, Federal Reserve Bank of New York; Goldstein, M. A., Hotchkiss, E. S., Sirri, E. R. (2007), 'Transparency and liquidity: A controlled experiment on corporate bonds', The Review of Financial Studies 20(2), 235-273; Botosan, C. A. (1997), 'Disclosure Level and the Cost of Equity Capital', The Accounting Review, Vol. 72, No 3, pp. 323-349.

[25] International Association of Insurance Supervisors (IAIS), 2011, 'Insurance and Financial Stability'.

II. European Systemic Risk Board

RECOMMENDATION

of 31 October 2016 on closing real estate data gaps (ESRB/2016/14) (2017/C 31/01)

amended by
Recommendation of the European Systemic Risk Board of 21 March 2019 (ESRB/2019/3) (2019/C 271/01)

SECTION 1

RECOMMENDATIONS

Recommendation A – Monitoring risks arising from the residential real estate sector

1. National macroprudential authorities are recommended to implement a risk monitoring framework for their domestic RRE sector, including information on current lending standards for domestic RRE loans. For this purpose, the following set of lending standards indicators is recommended for effective monitoring of risks arising from the RRE market:

(a) loan-to-value ratio at origination (LTV-O);

(b) current loan-to-value ratio (LTV-C);

(c) loan-to-income ratio at origination (LTI-O);

(d) debt-to-income ratio at origination (DTI-O);

(e) loan-service-to-income ratio at origination (LSTI-O);

(f) debt-service-to-income ratio at origination (DSTI-O) as optional indicator;

(g) number and amount of RRE loans disbursed;

(h) maturity of the RRE loans at origination.

The information on these indicators should relate to domestic credit providers on a solo basis and should be sufficiently representative of the domestic RRE loan market.

2. Where buy-to-let housing represents a significant source of risks stemming from the domestic real estate sector, possibly but not only because it constitutes a significant share of the stock or flows of total RRE lending, national macroprudential authorities are recommended to implement a risk monitoring framework based on a number of additional indicators for this market segment. Where no or limited quantitative information is available to assess the significance of buy-to-let housing, this assessment may initially have to be made on the basis of more qualitative information. The additional indicators for this market segment should include:

(a) interest coverage ratio at origination (ICR-O);

(b) loan-to-rent ratio at origination (LTR-O).

3. For the calculation of the indicators listed in paragraphs 1 and 2, national macroprudential authorities are recommended to follow the guidance specified in Annex IV to this Recommendation.

4. On the basis of the indicators laid down in paragraphs 1 and 2, national macroprudential authorities are recommended to monitor developments in the domestic RRE sector at least annually.

Recommendation B – Relevant information in relation to the residential real estate sector

1. National macroprudential authorities are recommended to monitor the univariate distribution and the selected joint distributions of the relevant indicators as specified in Template A of Annex II to this Recommendation. This template provides guidance on the granularity of the information relevant for the monitoring of risks arising from the domestic RRE sector.

2. National macroprudential authorities are recommended to monitor risks in relation to the different indicators on the basis of the following information as specified in Template A of Annex II to this Recommendation.

(a) For the flows of RRE loans granted in the reporting period, national macroprudential authorities should consider:
- the total number of contracts and the associated amount in national currency;
- the number of contracts and the associated amount in national currency broken down by the categories specified in Template A of Annex II to this Recommendation.

(b) For the LTV-O and LSTI-O related to the flows of RRE loans, national macroprudential authorities should consider:
- the weighted average of the relevant ratio expressed as a percentage;
- the weighted average of the relevant ratio expressed as a percentage broken down by the categories as specified in Template A of Annex II to this Recommendation;
- the number of contracts and the associated amount in national currency broken down by the distribution buckets as specified in Template A of Annex II to this Recommendation.

(c) For the DSTI-O (optional indicator) related to the flows of RRE loans, national macroprudential authorities should consider:
- the weighted average of the relevant ratio expressed as a percentage;
- the number of contracts and the associated amount in national currency broken down by the distribution buckets as specified in Template A of Annex II to this Recommendation.

(d) For the LTV-C related to the stock of RRE loans, national macroprudential authorities should consider:
- the weighted average of the relevant ratio expressed as a percentage;
- the number of contracts and the associated amount in national currency broken down by the distribution buckets specified in Template A of Annex II to this Recommendation.

(e) For the maturity at origination related to the flows of RRE loans, national macroprudential authorities should consider:
- the weighted average maturity in years;

- the number of contracts and the associated amount in national currency broken down by the distribution buckets specified in Template A of Annex II to this Recommendation.

(f) For LTI-O and DTI-O related to the flows of RRE loans, national macroprudential authorities should consider:
- the weighted average of the relevant ratio;
- the number of contracts and the associated amount in national currency broken down by the distribution buckets specified in Template A of Annex II to this Recommendation.

(g) For the joint distribution of LSTI-O, LTV-O and RRE loan maturity at origination of the flows of RRE loans, national macroprudential authorities should consider the number of contracts and the associated amount in national currency broken down by the categories specified in Template A of Annex II to this Recommendation.

(h) For the joint distribution of LSTI-O and the initial interest rate fixation period of the flows of RRE loans, national macroprudential authorities should consider the number of contracts and the associated amount in national currency broken down by the categories specified in Template A of Annex II to this Recommendation.

(i) For the joint distribution of DTI-O and LTV-O of the flows of RRE loans, national macroprudential authorities should consider the number of contracts and the associated amount in national currency broken down by the categories specified in Template A of Annex II to this Recommendation.

3. Where buy-to-let housing represents a significant source of risks stemming from the domestic RRE sector, possibly but not only because it constitutes a significant share of the stock or flows of total RRE lending, national macroprudential authorities are recommended to monitor risks in relation to the relevant indicators separately for buy-to-let housing and owner-occupied properties. In this case, national macroprudential authorities should consider also the breakdowns specified in Template B of Annex II to this Recommendation.

Recommendation C – Monitoring risks arising from the commercial real estate sector

1. National macroprudential authorities are recommended to implement a risk monitoring framework for their domestic CRE sector. For this purpose, the following set of indicators is recommended for effective monitoring of risks arising from the CRE market:

Indicators on the physical CRE market:

(a) price index;

(b) rental index;

(c) rental yield index;

(d) vacancy rates;

(e) construction starts;

Indicators on the financial system's CRE credit exposures:

(f) CRE lending flows (including CRE property under development or construction);

(g) flows of non-performing CRE loans (including CRE property under development or construction);

(h) flows of loan loss provisions on CRE lending (including CRE property under development or construction);

(i) flows of loan loss provisions on lending for CRE property under development or construction (as part of CRE lending);

(j) CRE lending stocks (including CRE property under development or construction);

(k) stocks of non-performing CRE loans (including CRE property under development or construction);

(l) stocks of loan loss provisions on CRE lending (including CRE property under development or construction);

(m) stocks of lending for CRE property under development or construction (as part of CRE lending);

(n) stocks of non-performing loans for CRE property under development or construction (as part of CRE lending);

(o) stocks of loan loss provisions on lending for CRE property under development or construction (as part of CRE lending).

Indicators on CRE lending standards:

(p) weighted average of the LTV-O for the flows of CRE loans;

(q) weighted average of the current loan-to-value ratio (LTV-C) for the stocks of CRE loans;

(r) weighted average of the interest coverage ratio at origination (ICR-O) for the flows of CRE loans and weighted average of the current interest coverage ratio (ICR-C) for the stocks of CRE loans;

(s) weighted average of the debt service coverage ratio at origination (DSCR-O) for the flows of CRE loans and weighted average of the current debt service coverage ratio (DSCR-C) for the stocks of CRE loans.

The information on these indicators should relate to credit providers on a solo basis and should be sufficiently representative of the domestic CRE market.

2. Where investments are deemed to represent a significant share of CRE financing, national macroprudential authorities are recommended to include in the risks monitoring framework for their domestic CRE sector also the following set of additional indicators on CRE investment exposures:

(a) direct and indirect CRE investment flows;

(b) valuation adjustments flows on CRE investments;

(c) direct and indirect CRE investment stocks;

(d) valuation adjustments stocks on CRE investments.

The information on these indicators should relate to investors on a solo basis and should be sufficiently representative of the domestic CRE market.

3. For the calculation of the indicators listed in paragraphs 1 and 2, national macroprudential authorities are recommended to follow the guidance specified in Annex V and, where appropriate for CRE, in Annex IV to this Recommendation.

4. On the basis of the indicators laid down in paragraphs 1 and 2, national macroprudential authorities are recommended to monitor developments in the domestic CRE sector at least quarterly for the physical market, lending and investment flows (including flows of non-performing loans, loan loss provisions and valuation adjustments on investments) and the corresponding lending standards. Such monitoring should take place at least annually for the stock of loans and investments (including stocks of non-performing loans, loan loss provisions and valuation adjustments on investments) and the corresponding lending standards.

Recommendation D – Relevant information in relation to the commercial real estate sector

1. National macroprudential authorities are recommended to monitor the relevant indicators as specified in Templates A, B and C of Annex III to this Recommendation. These templates provide guidance on the granularity of the information necessary to monitor risks arising from the domestic CRE sector.

2. National macroprudential authorities are recommended to monitor risks in relation to the different indicators on the basis of the following information as specified in Templates A, B and C of Annex III to this Recommendation:

(a) For the price index, rental index, rental yield index, vacancy rates and construction starts, national macroprudential authorities should consider a breakdown by:

- property type;
- property location.

(b) For flows and stocks of valuation adjustments on CRE investments, national macroprudential authorities should consider a breakdown by:

- property type;
- property location;
- investor type;
- investor nationality.

(c) For CRE lending flows and stocks and for each of the breakdowns of lending to CRE (including CRE property under development or construction) – i.e. lending for property held by owners for the purpose of conducting their business, purpose or activity, either existing or under construction; lending for rental housing; lending for income-producing real estate (other than rental housing); lending for CRE property under development; and lending for social housing – national macroprudential authorities should consider a further breakdown by:

- property type;
- property location;
- lender type;
- lender nationality.

(d) For flows and stocks of non-performing CRE loans and for each of the breakdowns of non-performing CRE loans (including CRE property under development or construction) – i.e. lending for property held by owners for the purpose of conducting their business, purpose or activity, either existing or under construction; lending for rental housing; lending for income-producing real estate (other than rental housing); lending for CRE property under development; and lending for social housing – national macroprudential authorities should consider a further breakdown by:

- property type;
- property location;
- lender type;
- lender nationality.

(e) For flows and stocks of loan loss provisions on CRE lending and for each of the breakdowns of loan loss provisions on CRE lending (including CRE property under development or construction) – i.e. lending for property held by owners for the purpose of conducting their business, purpose or activity, either existing or under construction; lending for rental housing; lending for income-producing real estate (other than rental housing); lending for CRE property under development; and lending for social housing – national macroprudential authorities should consider a further breakdown by:

- property type;
- property location;
- lender type;
- lender nationality.

The breakdowns as referred to in points (a) to (e) above are to be considered as the recommended minimum. National macroprudential authorities may add additional breakdowns as they may deem necessary for financial stability purposes.

3. Where investments are deemed to represent a significant share of CRE financing, national macroprudential authorities are recommended to include in the risks monitoring framework for their domestic CRE sector also the following set of additional information on CRE investment exposures as specified in Template B of Annex III to this Recommendation:

(a) For CRE investment flows and stocks, national macroprudential authorities should consider a breakdown by:

- direct CRE holdings;
- indirect CRE holdings.

(b) For direct CRE investment flows and stocks, national macroprudential authorities should consider a breakdown by:

- property type;
- property location;
- investor type;
- investor nationality.

(c) For indirect CRE investment flows and stocks, national macroprudential authorities should consider a breakdown by:

- investor type;
- investor nationality.

Recommendation E – Publication by the European Supervisory Authorities of exposure data to national commercial real estate markets

1. The European Banking Authority (EBA), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) are recommended to publish, at least annually, aggregated data on the exposures of the entities subject to their respective supervision to each national CRE market in the Union in accordance with the guidance

provided in Annex V.9 to this Recommendation. These aggregated data should be based on information available to the ESAs under existing reporting requirements.

Recommendation F – Establishment of a common minimum framework for the physical commercial real estate market

1. The Commission (Eurostat) is recommended to propose Union legislation establishing a common minimum framework for the development, production and dissemination of a database on indicators on the physical CRE market referred to in paragraphs (a) to (e) of sub-recommendation C(1).

2. The Commission (Eurostat) is also recommended to develop and promote statistical standards, sources, methods and procedures for developing the database on the indicators on the physical CRE market referred to in paragraphs (a) to (e) of sub-recommendation C(1), in particular to ensure the quality of this set of indicators and minimise the reporting burden.

SECTION 2

IMPLEMENTATION

1. Definitions

1. For the purposes of this Recommendation, and taking into account the further technical specifications in Annex IV and Annex V to this Recommendation, the following definitions apply:

(1) 'borrower' means the signatory, or cosignatory, of the RRE loan contract or CRE loan contract and receiving financing from the lender;

(2) 'buy-to-let loan' means the sum of all loans or loan tranches secured by the borrower on the buy-to-let property at the moment of loan origination;

(3) 'buy-to-let housing or property' means any RRE directly owned by a natural person primarily for letting to tenants;

(4) 'commercial real estate' (CRE) means any income-producing real estate, either existing or under development, including rental housing; or real estate used by the owners of the property for conducting their business, purpose or activity, either existing or under construction; that is not classified as RRE; and includes social housing. If a property has a mixed CRE and RRE use, it should be considered as different properties (based for example on the surface areas dedicated to each use) whenever it is feasible to make such breakdown; otherwise, the property can be classified according to its dominant use;

(5) 'commercial real estate (CRE) loan' means a loan extended to a legal entity aimed at acquiring income-producing real estate (or set of properties defined as income-producing real estate), either existing or under development, or real estate used by the owners of the property for conducting their business, purpose or activity (or set of such properties), either existing or under construction, or secured by a commercial real estate property (or set of commercial real estate properties);

(6) 'construction starts' means the surface area, in square metres, of new commercial construction projects begun during the reporting period; if such information is not

available, construction starts may refer to the number of new commercial construction projects begun during the reporting period;

(7) 'current loan-to-value ratio' (LTV-C) means the sum of all loans or loan tranches secured by the borrower on a property at the reporting date relative to the current value of the property;

(8) 'current value of the property' means the value of the property as assessed by an independent external or internal appraiser; if such assessment is not available, the current value of the property can be estimated using a real estate value index sufficiently granular with respect to geographical location and type of property; if such real estate value index is also not available, a real estate price index sufficiently granular with respect to geographical location and type of property can be used after application of a suitably chosen mark-down to account for the depreciation of the property;

(9) 'debt service' means the combined interest and principal repayment on a borrower's total debt over a given period (generally one year);

(10) 'debt service coverage ratio' (DSCR) means the annual rental income generated by a CRE property that is at least partially financed by debt, net of taxes and any operational expenses to maintain the property's value, relative to the annual debt service on the loan secured by the property; the ratio can refer to its value at loan origination (DSCR-O) or its current value (DSCR-C);

(11) 'debt-service-to-income ratio at origination' (DSTI-O) means the annual total debt service relative to the borrower's total annual disposable income at the moment of loan origination;

(12) 'debt-to-income ratio at origination' (DTI-O) means the total debt of the borrower at the moment of loan origination relative to the borrower's total annual disposable income at the moment of loan origination;

(13) 'disposable income' means the borrower's total yearly disposable income as registered by the credit provider at the moment of the RRE loan origination, covering all sources of income minus taxes (net of tax rebates) and premiums (such as for health care, social security or medical insurance), and before deduction of expenses;

(14) 'first time buyer' means a borrower to whom no RRE loan has been advanced before; in case there is more than one borrower (the case of RRE loan cosignatories) and one or more of these borrowers has previously been advanced an RRE loan, none of these borrowers is considered to be a first-time buyer;

(15) 'flows of loans' means any new production of loans over the reporting period; renegotiated loans should be included in the new production if the lender considers them as new loan contracts;

(16) 'fully amortising loan' means a RRE loan characterised by periodic principal repayments, according to an amortization schedule, over the life of the loan so that the principal is fully paid back at the maturity of the loan;

(16a) 'income-producing property under development' means all property under construction and intended to provide, upon completion, an income to its owner in the form of rents or profits from its sale, but does not include buildings being demolished or sites being cleared for possible development in the future;

(17) ‘income-producing real estate’ means all immovable properties with income generated by their rents or profits from their sale;

(18) ‘interest coverage ratio’ (ICR) means the gross annual rental income (i.e. before operational expenses and taxes) accruing from a buy-to-let property or the net annual rental income accruing from a CRE property or set of properties relative to the annual interest cost of the loan secured by the property or set of properties; the ratio can refer to its value at loan origination (ICR-O) or its current value (ICR-C);

(19) ‘loan loss provisions’ means the total amount of provisions made on loan portfolios to account for potential future credit losses;

(20) ‘loans disbursed’ means the total RRE loans (in number of loans or loan amount) granted in the reporting period;

(21) ‘loan service’ means the combined interest and principal repayment on a borrower’s RRE loan over a given period (generally one year);

(22) ‘loan service-to-income ratio at origination’ (LSTI-O) means the annual RRE loan service relative to the borrower’s total annual disposable income at the moment of loan origination;

(23) ‘loan-to-cost ratio’ (LTC) means the initial amount of all loans granted relative to the amount of costs associated with the development of a property until completion;

(24) (24) ‘loan-to-income ratio at origination’ (LTI-O) means the sum of all loans or loan tranches secured by the borrower on the immovable property at the moment of loan origination relative to the borrower’s total annual disposable income at the moment of loan origination;

(25) ‘loan-to-rent ratio at origination’ (LTR-O) means the buy-to-let loan of the borrower at the moment of loan origination relative to the gross annual rental income (i.e. before operational expenses and taxes) accruing from the buy-to-let property;

(26) ‘loan-to-value ratio at origination’ (LTV-O) means the sum of all loans or loan tranches secured by the borrower on the immovable property at the moment of loan origination relative to the value of the property at the moment of loan origination;

(27) ‘maturity at origination’ means the duration of the RRE loan contract expressed in years at the moment of loan origination;

(28) ‘national macroprudential authority’ means the authority entrusted by national legislation with the conduct of macroprudential policy as recommended in Recommendation B of Recommendation ESRB/2011/3 of the European Systemic Risk Board;[1]

(29) ‘non-amortising loan’ means a RRE loan characterized by periodic payments of, at most, only the interest on the loan; where relevant, non-amortising loans for which redemption vehicles exist should be identified separately;

(30) ‘non-performing loans’ mean any credit exposures that satisfy either or both of the following criteria:

(a) material exposures that are more than 90 days past-due;
(b) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due;

(31) 'owner occupied loan' means the sum of all RRE loans or loan tranches secured by the borrower on an owner occupied RRE property at the moment of loan origination;

(32) 'owner occupied housing or property' means any residential real estate owned by a natural person for the purpose of providing shelter to its owner;

(33) 'partially amortising loans' means a combination of multiple RRE loans of different amortisation types;

(34) 'real estate value index' means an index that reflects both the change in price and quality of the property over time, such as an index constructed on the basis of transaction data;

(35) 'rent' means the amount of money actually paid by the tenant to the owner of the property, net of any incentives (e.g. rent free periods, contributions to refurbishment) and charges;

(35a) 'rental housing' means any real estate which is owned by legal entities primarily for letting to tenants;

(36) 'rental yield' means the ratio of annual rents to the market value of the immovable property;

(37) 'residential real estate' (RRE) means any immovable property available for dwelling purposes, either existing or under construction, acquired, built or renovated by a natural person, including buy-to-let housing. If a property has a mixed use, it should be considered as different properties (based for example on the surface areas dedicated to each use) whenever it is feasible to make such breakdown; otherwise, the property can be classified according to its dominant use;

(38) 'residential real estate (RRE) loan' means a loan to a natural person secured by a residential real estate property, independent of the purpose of the loan;

(39) 'risk monitoring framework' means a regular process of monitoring and assessing of the systemic risks stemming from the domestic real estate market, based on sound analytical methods and sufficiently representative data;

(40) 'sufficiently representative data' means data obtained by sampling techniques which refer to relevant characteristics known to be present in the statistical population; no specific sampling techniques are prescribed and national practices are considered adequate as long as, according to expert judgement, they can be considered to produce non-biased results;

(41) 'vacancy rate' means the surface area available for rent relative to the total surface area of the property;

(42) 'valuation adjustments on investments' means costs incurred by an investor to account for the potential future loss on investments due to prevailing market conditions;

(43) 'value at origination' means the lower of the transaction value of an immovable property (for example as registered in a notarial deed) and the value as assessed by an independent external or internal appraiser at loan origination; if only one value is available, this value should be used.

2. Criteria for implementation

1. The following criteria apply to the implementation of the Recommendation:

(a) the Recommendation covers only indicators necessary for financial stability purposes and for which data gaps were identified;

(b) due regard should be paid to the principle of proportionality, taking into account:

  (i) the size and development of the CRE and RRE markets in Member States;
  (ii) the powers of each national macroprudential authority;
  (iii) the objective and content of each Recommendation;

(c) while assessing the implementation of Recommendations A to D, due regard should also be paid to the progress made on the data collection at Union level as referred to in Recital (15);

(d) specific criteria for compliance with Recommendations A to E are set out in Annex I to this Recommendation.

2. Addressees are requested to report to the ESRB and the Council on the actions undertaken in response to this Recommendation, or adequately justify any inaction. The reports should at minimum contain:

(a) information on the substance and timeline of the actions undertaken;

(b) an assessment of the functioning of the actions undertaken, having regard to the objectives of this Recommendation;

(c) detailed justification of any inaction or departure from this Recommendation, including any delays.

3. Timeline for the follow-up

Addressees are requested to report to the ESRB and the Council on the actions taken in response to this Recommendation, or adequately justify any inaction, in compliance with the following timelines.

(1) Recommendation A

  (a) By 31 December 2019, national macroprudential authorities are requested to deliver to the ESRB and the Council an interim report on the information already available, or expected to be available, for the implementation of Recommendation A.
  (b) By 31 December 2020, national macroprudential authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation A.

(2) Recommendation B

  (a) By 31 December 2019, national macroprudential authorities are requested to deliver to the ESRB and the Council an interim report on the information already available, or expected to be available, for the implementation of Recommendation B.

(b) By 31 December 2020, national macroprudential authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation B.

(3) Recommendation C

(a) By 31 December 2019, national macroprudential authorities are requested to deliver to the ESRB and the Council an interim report on the information already available, or expected to be available, for the implementation of Recommendation C.

(b) By 31 December 2021, national macroprudential authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation C.

(c) Where national macroprudential authorities do not have the relevant information in relation to those indicators referred to in points (a) to (e) of Recommendation C(1), those authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation C in relation to those indicators at the latest by 31 December 2025.

(4) Recommendation D

(a) By 31 December 2019, national macroprudential authorities are requested to deliver to the ESRB and the Council an interim report on the information already available, or expected to be available, for the implementation of Recommendation D.

(b) By 31 December 2021, national macroprudential authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation D.

(c) Where national macroprudential authorities do not have the relevant information in relation to those indicators referred to in point (a) of Recommendation D(2) as specified in Template A of Annex III to this Recommendation, those authorities are requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation D in relation to those indicators at the latest by 31 December 2025.

(5) Recommendation E

(a) By 31 December 2017, the ESAs are requested to define a template for the publication of data on the exposures of the entities under the scope of their supervision to each of the national CRE markets in the Union.

(b) By 30 June 2018, the ESAs are requested to publish the data referred to in point (a) as at 31 December 2017.

(c) Starting on 31 March 2019, the ESAs are requested to publish on an annual frequency, the data referred to in point (a) as at 31 December of the preceding year.

(6) Recommendation F

(a) By 31 December 2021, the Commission (Eurostat) is requested to deliver to the ESRB and the Council an interim report containing a first assessment of the implementation of Recommendation F.

(b) By 31 December 2023, the Commission (Eurostat) is requested to deliver to the ESRB and the Council a final report on the implementation of Recommendation F.

4. Monitoring and assessment

(1) The ESRB Secretariat will:

(a) assist the addressees, ensuring the coordination of reporting, the provision of relevant templates and detailing where necessary the procedure and the timeline for the follow-up;

(b) verify the follow-up by the addressees, provide assistance at their request, and submit follow-up reports to the General Board via the Steering Committee.

(2) The General Board will assess the actions and justifications reported by the addressees and, where appropriate, may decide that this Recommendation has not been followed and that an addressee has failed to provide adequate justification for its inaction.

[1] Recommendation ESRB/2011/3 of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (OJ C 41, 14.2.2012, p. 1).

ANNEX I

COMPLIANCE CRITERIA FOR THE RECOMMENDATIONS

1. Recommendation A

National macroprudential authorities will be deemed to comply with Recommendations A(1) and A(2), where they:

(a) assess whether the relevant indicators on lending standards for RRE loans are considered or implemented in the risk monitoring framework of the RRE sector in their jurisdiction;

(b) assess progress on the use of the indicators specified in Recommendation A(1) for such monitoring;

(c) assess the extent to which the information, already available or expected to be available in the future, on the relevant indicators is sufficiently representative of current lending standards in their RRE loan market;

(d) assess whether buy-to-let housing represents a significant source of risks stemming from the domestic real estate sector or constitutes a significant share of the stock or flows of total RRE lending;

(e) in cases where buy-to let housing is considered a significant source of risks stemming from the domestic real estate sector or constitutes a significant share of the stock or flows of total RRE lending, assess progress on the use of the indicators for risk monitoring specified in Recommendation A(2).

National macroprudential authorities will be deemed to comply with Recommendations A(3) and A(4) where they:

(a) ensure the adoption of the methods specified in Annex IV for the calculation of the indicators listed in Recommendations A(1) and A(2);

(b) in cases where another method is used in addition to that specified in Annex IV for the calculation of the relevant indicators, report on the method's technical features and its effectiveness in monitoring risks arising from the RRE sector;

(c) ensure that the relevant indicators listed in Recommendations A(1) and A(2) are used to monitor risks in the RRE sector at least annually.

2. Recommendation B

National macroprudential authorities will be deemed to comply with Recommendations B(1) and B(2), where they:

(a) assess progress on the monitoring of the univariate distribution and the selected joint distributions of the relevant indicators as specified in Template A of Annex II;

(b) assess progress on the use of the information specified in Recommendation B(2) and in Template A of Annex II as a guidance to monitor the relevant risks.

In cases where buy-to-let housing is considered a significant source of risks stemming from the domestic real estate sector or constitutes a significant share of the stock or flows of total RRE lending, national macroprudential authorities will be deemed to comply with Recommendation B(3) where they:

(a) assess progress on the separate monitoring of the relevant indicators for buy-to-let housing and owner occupied properties;

(b) assess progress on the monitoring of the relevant data broken down by the dimensions as specified in Templates A and B of Annex II.

3. Recommendation C

National macroprudential authorities will be deemed to comply with Recommendations C(1) and C(2) where they:

(a) assess whether the relevant indicators for domestic CRE exposures are considered or implemented in the risk monitoring framework for the CRE sector in their jurisdiction;
(b) ensure inclusion in the risk monitoring framework of the indicators on the physical CRE market, the indicators on financial system credit exposures and the indicators on lending standards;
(c) assess whether investments represent a significant source of financing for the domestic CRE sector;
(d) in cases where investments are considered a significant source of financing for the domestic CRE sector, assess progress on the use of the additional indicators for risk monitoring specified in Recommendation C(2);
(e) assess progress on the use of the indicators specified, at a minimum, in Recommendation C(1) and, where applicable, in Recommendation C(2);
(f) assess whether the information on these indicators (already available or expected to be available) is sufficiently representative of the domestic CRE market.

National macroprudential authorities will be deemed to comply with Recommendations C(3) and C(4) where they:

(a) ensure the adoption of the methods for the calculation of the indicators listed in Recommendation C(1) and Recommendation C(2) as specified in Annex V and, where appropriate for CRE, in Annex IV;

(b) in cases where another method is used in addition to that specified in Annex IV and Annex V for the calculation of the relevant indicators, report on the method's technical features and its effectiveness in monitoring risks arising from the CRE sector;

(c) ensure that the indicators listed in Recommendation C(1) are used to monitor developments in the CRE sector at least quarterly for indicators on the physical CRE market, lending flows (including flows of non-performing loans and loan loss provisions) and the corresponding lending standards, and at least annually for stocks of loans (including stocks of non-performing loans and loan loss provisions) and the corresponding lending standards;

(d) in cases where investments are considered a significant source of financing for the domestic CRE sector, ensure that the indicators listed in Recommendation C(2) are used to monitor developments in the CRE sector at least quarterly for investment flows (including valuation adjustments on investments) and at least annually for stocks of investments (including valuation adjustments on investments).

4. Recommendation D

National macroprudential authorities will be deemed to comply with Recommendation D where they:

(a) assess progress in monitoring the relevant indicators as specified in Templates A, B and C of Annex III;

(b) assess progress on the use of the relevant information as specified in Recommendation D(2) and indicated in Templates A, B and C of Annex III as a guidance to monitor the relevant risks;

(c) in cases where investments are considered a significant source of financing for the domestic CRE sector, assess progress on the use of the relevant information as specified in Recommendation D(3) and indicated in Template B of Annex III as a guidance to monitor relevant risks;

(d) in cases where additional indicators are used to monitor developments in the CRE sector, report on the additional information used for monitoring risks.

5. Recommendation E

The ESAs will be deemed to comply with Recommendation E where they:

(a) define a template for the publication of data on the exposures of the entities under the scope of their supervision to each national CRE market in the Union;

(b) publish at least annually aggregated data collected under existing reporting requirements on the exposures of the entities under the scope of their supervision to each national CRE market in the Union.

6. Recommendation F

The Commission (Eurostat) will be deemed to comply with Recommendation F where:

(a) based on the suitability of the definitions and breakdowns for the relevant indicators on the physical CRE market which are currently used within Member States, it proposes Union legislation establishing a common minimum framework for the development, production and dissemination of a database on the relevant indicators with the aim of harmonising such indicators;

(b) it ensures the alignment of the proposed legislation with the indicators and their definitions, as used for supervisory or financial stability purposes, so as to avoid an unjustified increase in the burden on reporting entities;

(c) it ensures the quality of the relevant indicators on the physical CRE market by developing statistical standards, sources, methods and procedures for developing the database on the relevant indicators;

(d) it ensures that the implementation of the developed statistical standards, sources, methods and procedures relating to the database on the relevant indicators on the physical CRE market does not lead to an unjustified increase in the burden on reporting entities;

(e) it promotes the implementation of the statistical standards, sources, methods and procedures developed for the production of the database on relevant indicators on the physical CRE market.

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ANNEX V

GUIDANCE ON DEFINITIONS AND INDICATORS

This Annex provides guidance on specific issues related to the definition of indicators and in particular on Annex III. Its purpose is not to provide detailed technical instructions for completing the Templates of Annex III covering all possible cases. Moreover, the guidance should be interpreted as covering target definitions and target methods, and in some cases divergences might be justified to accommodate for the specificities of markets or market segments.

1. Definitions of commercial real estate

There is currently no Union-wide definition of CRE that is sufficiently precise for macroprudential purposes.

(a) Regulation (EU) No 575/2013 defines RRE in Article 4(1)(75) but does not provide a precise definition of CRE, other than describing it as 'offices or other commercial premises' in Article 126. This Regulation also requires that the property value should not depend on the credit quality of the borrower or the performance of the underlying project as regards CRE.

(b) EBA provided a useful additional criterion: the dominant purposes of the property 'should be linked to an economic activity'.[1] While useful, this criterion is still not precise enough for macroprudential purposes.

(c) Regulation (EU) 2016/867 of the European Central Bank (ECB/2016/13)[2] is another possible source for the definition of CRE. While the premise on which this Recommendation was originally issued justified the adoption of more detailed definitions for financial stability purposes, recent developments in statistics have highlighted the need to align more closely the definition of CRE with that in Regulation (EU) 2016/867, in order to facilitate the monitoring activities and financial analyses of national macroprudential authorities and to allow for complete comparability between countries.

(d) The G20 Data Gaps initiative[3] is a set of 20 recommendations on the enhancement of economics and financial statistics that was launched in order to improve the availability and comparability of economic and financial data following the financial crisis of 2007-08. Recommendations II.17 and II.18 of the Second Phase of the G20 Data Gaps Initiative (DGI- 2)[4] highlight the requirement to improve the availability of both residential and commercial real estate statistics. Following up on this initiative, in 2017, the Commission (Eurostat) published a report on 'Commercial property price indicators: sources, methods and issues',[5] which provides input on the source data and methodologies in relation to commercial property price indices, with the aim of better informing compilers and users of alternative data sources, measurement methods, and the issues at stake.

(e) The Basel Committee on Banking Supervision's consultation document on revisions to the standardised approach for credit risk[6] also defines CRE as the opposite of RRE. An RRE exposure is defined as an exposure secured by an immovable property that has the nature of a dwelling and satisfies all applicable laws and regulations enabling the property to be occupied for housing purposes, i.e. residential property. A CRE exposure is then defined as an exposure secured by any immovable property that is not a residential property.

In view of the limitations of the definitions set out above, this Recommendation provides a working definition of CRE specifically for macroprudential purposes. It defines CRE as any income-producing real estate, either existing or under development, including rental housing; or real estate used by the owners of the property for conducting their business, purpose or activity, either existing or under construction; that is not classified as RRE; and includes social housing.

Whether property under development should be considered as CRE can be debated. In this respect national practices vary. However, the experience of a number of Member States during the recent financial crisis has demonstrated how important it is for financial stability purposes to monitor investments in, and the financing of, this economic activity.

Income-producing real estate is defined as all immovable properties with income generated by their rents or profits from their sale. Therefore, buy-to-let housing and rental housing are both sub-categories of income-producing real estate.

Buy-to-let housing refers to any real estate directly owned by natural persons, with the primary aim of being let to tenants. Buy-to-let housing is a border area between RRE and CRE. However, since this activity is typically undertaken by part-time, non-professional landlords with a small property portfolio this can be interpreted for financial stability purposes as belonging more to the RRE sector rather than to the CRE sector. For this reason buy-to-let housing is classified as RRE and is therefore automatically excluded from the definition of CRE, even though it is still considered to be income-producing real estate. Nevertheless, because of its distinct risk characteristics, national macroprudential authorities are recommended to monitor developments in this sub-market under a separate breakdown, should this activity represent a significant source of risks or a significant share of the stock or flows of total RRE lending. For this reason, a breakdown of RRE loans has also been included to distinguish between buy-to-let loans and owner occupied loans. Buy-to-let housing which is under construction is also deemed to be RRE. Similarly, dwellings which are being constructed with the aim of being used for dwelling purposes by the owners are also deemed to be RRE property.

Rental housing refers to real estate which is owned by legal entities (such as professional investors) with the aim of being let to tenants. Such properties are also deemed to be income-producing real estate and as such are classified as CRE. In addition, rental housing which is under construction is also classified as CRE, and in particular as income-producing real estate under development. Separate monitoring of the financing of rental housing may also be relevant for financial stability purposes. For this reason, separate breakdowns have been included for these types of loans.

Income-producing real estate other than buy-to-let housing and rental housing is also included in the definition of CRE, whether existing or under construction. Examples of such other types of income-producing real estate include rented office buildings and rented business premises. When under construction, such types of income-producing real estate are considered to be income-producing real estate under development, which is classified as CRE.

Real estate used by the owners of the property for conducting their business, purpose or activity includes business premises, as well as real estate of a more sui generis nature, such as churches, universities, museums, etc. Whether real estate used by the owners of the property for conducting their business, purpose or activity should be classified as CRE or as another type of real estate can be debated. In this respect, national practices vary, since the risks associated with such real estate may, in some Member States, be considered to be different from the risks associated with CRE. Nevertheless, while acknowledging that the risks may vary across Member States, it is also important to monitor such risks for financial stability purposes. For this reason, real estate used by the owners of the property for conducting their business, purpose or activity has been included in the definition of CRE. In addition, to cater for the specificities of the financing of the different real estate markets across Member States, separate breakdowns are also included in order to monitor risks connected to these types of financing separately. Real estate used by the owners of the property for conducting their business, purpose or activity should also be considered as CRE both during the construction phase and upon completion.

Social housing is a complex segment of the real estate market, as it may take different forms across and within Member States. Given that social housing is not usually built, acquired or renovated by natural persons, it is not classified as RRE, but as CRE. However, in some countries, in view of financial stability considerations, it is important to monitor the risks stemming from this type of property under a separate breakdown. For this reason, separate breakdowns have been added for these types of loans. In addition, social housing which is owned directly by the State is deemed to be owned for the purpose of conducting the government's purpose and is therefore also classified as CRE. Social housing which is still under construction is also classified as CRE, as it is considered as income-producing real estate under development.

Any other properties under construction should be considered as either RRE or CRE in accordance with the general definitions in points (4) and (38), respectively, of section 2(1)(1).

2. Data sources on commercial real estate

2.1. Indicators on the physical CRE market

CRE indicators on the physical market can be obtained through:

(a) public sources, e.g. national statistical agencies or land registers; or

(b) private sector data providers that cover a substantial part of the CRE market.

The ESRB Report on commercial real estate and financial stability in the EU provides an overview of available price indices and possible data sources.[7]

2.2. Indicators on the financial system's CRE exposure

The exposures of market participants, at least those of the financial sector, can be collected from supervisory reporting. Some data are already collected by the ECB and EIOPA at national level. However, these are not very detailed. New supervisory reporting templates for banks, i.e. Financial Reporting (FINREP) and Common Reporting (COREP), for insurers under Directive 2009/138/EC of the European Parliament and of the Council[8] and for investment funds under Directive 2011/61/EU of the European Parliament and of the Council[9] can provide more granular insight into financial institutions' exposures to CRE.

The classifications provided in the statistical classification of economic activities in the European Community (NACE rev 2.0) can be useful to proxy financial institutions' exposures to CRE, as they are widely agreed upon by the Union institutions and used in regulatory reporting templates for banks and insurance undertakings. Two sections appear to be relevant in that respect:

(a) Section F: construction, excluding civil engineering; and

(b) Section L: real estate activities, excluding real estate agencies.

The main drawback of using NACE classifications is that they target economic sectors and not loans. For instance, a loan extended to a property company to buy a car fleet will be reported under Section L, even if it is not a CRE loan.

2.3. Use of private sector data

Where national macroprudential authorities use data from a private sector data provider in order to compile the CRE indicators, they are expected to identify the differences in scope and definitions compared to those requested in this Recommendation. They should also be able to provide details on the underlying methodology used by the provider and the sample coverage. Data from a private sector provider should be representative of the overall market and the relevant breakdowns set out in Recommendation D:

(a) property type;

(b) property location;

(c) investor type and nationality;

(d) lender type and nationality.

3. Relevant breakdowns of the indicators

With respect to the relevant breakdowns set out in Recommendation D, national macroprudential authorities should be able to provide an assessment of the relevance of such breakdowns for their CRE market when they use them for monitoring purposes, taking also into account the principle of proportionality.

'Property type' refers to the primary use of a commercial property. For CRE indicators, this breakdown should include the following categories:

(a) residential, e.g. multi-household premises;

(b) retail, e.g. hotels, restaurants, shopping malls;

(c) offices, e.g. a property primarily used as professional or business offices;

(d) industrial, e.g. property used for the purposes of production, distribution and logistics;

(e) other types of commercial property.

If a property has a mixed use, it should be considered as different properties (based for example on the surface areas dedicated to each use) whenever it is feasible to make such breakdown; otherwise, the property can be classified according to its dominant use.

'Property location' refers to the geographical breakdown (e.g. by regions) or to real estate sub-markets, which shall also include prime and non-prime locations. A prime location is generally considered the best location in a particular market, which is also reflected in the rental yield (typically the lowest in the market). For office buildings this could be a central location in a major city. For retail buildings this may refer to a city centre with many pedestrians or a centrally-placed shopping centre. For logistics buildings this may refer to a location where the necessary infrastructure and services are in place, which has excellent access to transport networks.

'Property territory' refers to the territory where the property that serves as collateral for a loan provided within the domestic financial system of any Member State is located. This breakdown should include the following sub-categories:

(a) domestic territory;

(b) foreign territory broken down into individual countries which the national macroprudential authorities of the Member State deem important for financial stability purposes.

'Investor type' refers to broad investor categories, such as:

(a) banks;

(b) insurance companies;

(c) pension funds;

(d) investment funds;

(e) property companies;

(f) others.

It is probable that only data on the recorded borrower or investor will be available. However, national macroprudential authorities should be aware that the recorded borrower or investor can be different from the ultimate borrower or investor, which is where the final risk lies. Hence, authorities are encouraged to monitor also information on the ultimate borrower or investor whenever possible, e.g. through information gathered from market participants, in order to have a better understanding of the behaviour of market participants and risks.

'Lender type' refers to broad lender categories, such as:

(a) banks, including 'bad banks';

(b) insurance companies;

(c) pension funds.

National macroprudential authorities may need to adjust the list of investor and lender types in order to reflect the characteristics of the local CRE sector.

'Nationality' refers to the country of incorporation of the market participant. The nationality of investors and lenders should be broken down into at least the three following geographical categories:

(a) domestic;

(b) rest of the European Economic Area;

(c) rest of the world.

National macroprudential authorities should be aware that the recorded investor's or lender's nationality can be different from the nationality of the ultimate investor or lender where the final risk lies. Hence, authorities are encouraged to also monitor information on the ultimate lender's or investor's nationality, e.g. through information gathered from market participants.

The breakdowns set out in Recommendation D(2) are to be considered as the recommended minimum. However, national macroprudential authorities are not prevented from making use of any additional breakdowns which, based on their own definitions and metrics, and taking into consideration the specificities of their national CRE markets, they may deem necessary for financial stability purposes. With respect to these additional breakdowns, national macroprudential authorities may choose to monitor and categorise these market segments as they deem appropriate for their national CRE markets. Moreover, where certain sub-categories of CRE or RRE are not deemed to be of relevance for financial stability purposes, national macroprudential authorities may choose not to monitor the risks stemming from such types of property and/or from their financing. In such cases, inaction by national macroprudential authorities will be deemed to be justified provided that sufficient explanations are provided.

4. Methods for calculating the physical market indicators

CRE price refers to a constant quality numéraire, i.e. the market value of property stripped of quality changes such as depreciation (and obsolescence) or appreciation (e.g. renovation) by means of quality adjustment.

Guidance from work initiated by Eurostat advises that pricing data should be collected from actual transactions. Where these are not available and/or fully representative they may be approximated by appraisal or valuation data as long as these data reflect the current market price, and not any sustainable price measurement approach.

5. Assessment of financial system exposures to commercial real estate

The financial system's exposure to CRE consists of both lending, often by banks and sometimes also insurance companies, and investments, often made by insurance companies, pension funds and investment funds. Investments can refer to both direct CRE holdings, e.g. possessing legal title to a CRE property, and indirect CRE holdings, e.g. through securities and investment funds. In case a lender or investor uses a special purpose vehicle (SPV) as a dedicated CRE financing technique, such lending or investments should be considered as direct CRE lending or holdings ('look-through' approach).

When assessing these exposures for the system, as a whole, national macroprudential authorities should be aware of the risk of double-counting. Investors can invest both directly and indirectly in CRE. For example, pension funds and insurance companies often invest indirectly in CRE.

It may also be more difficult to capture exposures of foreign market participants, which may make up a significant part of the market.[10] Since these market participants are important to the functioning of the CRE market, monitoring of their activities is advisable.

Since losses from CRE activities are often concentrated in CRE lending by banks, national macroprudential authorities are encouraged to pay particular attention to this activity in their monitoring.

6. Methods for calculating LTV

Annex IV sets out the methods for calculating LTV-O and LTV-C. However, there are a number of specificities to take into account when these ratios are calculated for CRE.

In the case of a syndicated loan, the LTV-O should be calculated as the initial amount of all loans granted to the borrower relative to the value of the property at origination. Where several properties are concerned, the LTV-O should be calculated as the ratio of the initial loan(s) amount to the total value of the properties concerned.

As the number of properties is much smaller and properties are more heterogeneous in the CRE sector than in the RRE sector, it is more appropriate to calculate the LTV-C on the basis of a value assessment of the individual properties rather than using a value or price index.

Finally, national macroprudential authorities need to monitor the distribution of LTV with a particular focus on the riskiest loans, i.e. those with the highest LTV, as losses often result from such tail risk.

7. Methods for calculating the interest coverage ratio (ICR) and debt service coverage ratio (DSCR)

The interest coverage ratio (ICR) and the debt service coverage ratio (DSCR) refer to rental income generated by an income-producing property or set of properties, or to cashflow generated by the conduct of the business, purpose or activity of the owners of a property or set of properties, net of taxes and operating expenses that the borrower must incur in order to maintain the property's value and – in the case of cashflow – adjusted for other costs and benefits directly connected with the use of the property.

ICR is defined as:

ICR = Net annual rental income : Annual interest costs

For the purposes of calculating ICR:

(a) 'net annual income' includes the annual rental income accruing from renting property to tenants or the annual cashflow generated by the conduct of the business, purpose or activity of the owners of the property, net of taxes and any operational expenses to maintain the property's value and – in the case of cashflow – adjusted for other costs and benefits directly connected with the use of the property.

(b) 'annual interest costs' are annual interest costs associated with the loan secured by the CRE property or set of properties.

The ICR's purpose is to measure the extent to which the income generated by a property is sufficient to pay for the interest expenses incurred by a borrower to purchase that property. ICR should therefore be analysed at property level.

DSCR is defined as:

DSCR = Net annual rental income / Annual debt service

For the purpose of calculating DSCR:

(a) 'net annual income' is the annual rental income accruing from renting property to tenants or the annual cashflow generated by the conduct of the business, purpose or activity of the owners of the property, net of any taxes and operational expenses to maintain the property's value and – in the case of cashflow – adjusted for other costs and benefits directly connected with the use of the property.

(b) 'annual debt service' is the annual debt service associated with the loan secured by the CRE property or set of properties.

The DSCR's purpose is to assess the weight of the overall debt burden that a property generates for a borrower. Hence, the denominator includes not only interest expenses, but also loan amortisation, i.e. principal repayments. The main issue for such an indicator is whether it should be calculated at property level or at borrower level. CRE financing is typically provided on a non-recourse basis, i.e. the lender is only entitled to repayment from the income of the property and not from the borrower's other income or assets. Therefore it is more realistic and appropriate to calculate the DSCR at property level. Furthermore, focusing on a borrower's overall income would raise important consolidation issues which would make it more difficult to define a metric that is comparable across Member States.

8. Additional indicators relevant for income-producing property under development

For income-producing property under development, instead of the LTV at origination, national macroprudential authorities may instead monitor the loan-to-cost ratio (LTC). The LTC represents the initial amount of all loans granted in relation to the costs associated with the construction of the property until completion.

In addition, national macroprudential authorities should focus their monitoring on the riskiest developments, e.g. those that experience very low pre-let or pre-sale ratios. For any building still being constructed, the pre-let ratio equals the surface area that has already been let by the property developer at the time the loan is issued relative to the total surface area that will be available once the property has been completed; similarly, the pre-sale ratio equals the surface area that has already been sold by the property developer at the time the loan is issued relative to the total surface area that will be available once the property has been completed.

9. Annual publication of commercial real estate exposures by the ESAs

Drawing on information available from regulatory reporting templates, the ESAs are recommended to disclose at least annually aggregated information on the exposures to the different national CRE markets in the Union for the entities within the scope of their supervision and on solo basis. Such public disclosure is expected to enhance the knowledge of national macroprudential authorities on the activity of entities from other Member States on their domestic CRE market. In case there are any concerns about the scope or quality of the published data, such publication should be accompanied with the appropriate comments.

As a general rule, the ESAs should make it possible for any national macroprudential authority in the Union to assess the exposures of all Union financial institutions to its national market. This implies that data collected for all financial institutions in the Union should be aggregated at country level.

In disclosing such aggregated information, the ESAs should make use of information in regulatory reporting templates that provide a geographical breakdown of credit exposures and/or (direct and indirect) investments. When reporting templates provide a breakdown by NACE codes,[11] CRE could be referred to as both the 'F' and 'L' Sections, although strictly speaking some sub-categories would need to be excluded following the CRE definition adopted in this Recommendation.

1 See: EBA question ID 2014_1214 of 21 November 2014.

2 Regulation (EU) 2016/867 of the European Central Bank of 18 May 2016 on the collection of granular credit and credit risk data (ECB/2016/13) (OJ L 144, 1.6.2016, p. 44).

3 Financial Stability Board and International Monetary Fund, The financial crisis and information gaps – report to the G-20 finance ministers and central bank governors, 29 October 2009.

4 Financial Stability Board and International Monetary Fund, Sixth Progress Report on the Implementation of the G-20 Data Gaps Initiative, September 2015.

5 'Commercial property price indicators: sources, methods and issues', Statistical Reports 2017 edition, Eurostat, Publications office of the European Union, 2017.

6 Basel Committee on Banking Supervision, Revisions to the Standardised Approach to credit risk – second consultative document, December 2015.

7 ESRB, Report on Commercial Real Estate and Financial Stability in the EU, December 2015, in particular Annex II, Section 2.2.

8 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (OJ L 335, 17.12.2009, p. 1).

9 Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 (OJ L 174, 1.7.2011, p. 1).

10 ESRB, 'Report on Commercial Real Estate and Financial Stability in the EU', December 2015, in particular Section 2.3 and Box 1.

11 Regulation (EC) No 1893/2006 of the European Parliament and of the Council of 20 December 2006 establishing the statistical classification of economic activities NACE Revision 2 and amending Council Regulation (EEC) No 3037/90 as well as certain EC Regulations on specific statistical domains (OJ L 393, 30.12.2006, p. 1).

III. European Systemic Risk Board

RECOMMENDATION

ESRB/2016/14 as amended by Recommendation ESRB/2019/3 on closing real estate data gaps. Questions and answers

Introduction

The aim of this document is to assist technicians with the implementation of Recommendation ESRB/2016/14[1] as amended by Recommendation ESRB/2019/3. It is to be read in conjunction with the Recommendation, but is not an integral part of it and therefore does not impose an "act or explain" obligation.

The document draws on input provided by the Real Estate Task Force (RETF) of the Statistics Committee (STC) of the European System of Central Banks (ESCB) and is designed as a living document that is updated regularly.

Should you require any further clarifications or have specific additional questions, please send an email to ESRBSecretariat@esrb.europa.eu.

1. Direct and indirect investment

1.1 What is the difference between direct and indirect investment?

The Recommendation requests addressees to report, in countries where investments are deemed to represent a significant share of commercial real estate (CRE), an additional set of indicators on CRE investment exposures, distinguishing between direct and indirect investment.

The difference between the two types of investment can be illustrated with the following examples:

- End-investors (e.g. banks, insurers, pension funds) can buy property directly (direct investment). Direct investment also includes properties owned by investors for their own use. However, properties foreclosed by credit providers as a result of lending operations (as opposed to properties held for the purpose of generating income) are not part of direct investment.
- Indirect investment comprises investments in securities funds, such as funds or real estate investment trusts (REITs), equity investments and holdings of commercial mortgage-backed securities (CMBS).

If a lender or investor uses a special purpose vehicle (SPV) as a dedicated CRE financing technique, such lending or investment should be regarded as direct CRE lending or investment (under the "look-through" approach).

2. Non-performing loans

2.1 How are non-performing loans defined in the context of the Recommendation?

For the purpose of identifying non-performing loans (NPLs), the Recommendation refers to any credit exposures that satisfy either or both of the following criteria: (i) material exposures that are more than 90 days past due; and (ii) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.

This definition of NPLs is the same as that used in financial reporting (FINREP) under Commission Implementing Regulation (EU) No 680/2014.[2]

3. Renegotiated loans in new loans production

3.1 Should renegotiated loans be included in indicators on flows of loans and new loans production?

The topping-up of renegotiated loans (i.e. increasing the size of existing loans) should be included in new production directly – in addition to entirely new loan agreements concluded during the reporting period. By adding the volume of such renegotiation top-ups to the volume of new loans, the gross flow of new loans to the real economy can be determined. However, national macroprudential authorities which are able to distinguish between truly new residential real estate (RRE) loans and renegotiated loans have the option of considering renegotiated loans in a separate breakdown.

4. Bridging loans

4.1 Should bridging loans be included in the calculation of indicators on flows and stocks of loans?

Bridging loans are to be excluded from the reporting. Such loans are defined as non-amortising real estate loans used to facilitate a transaction. For example, they can be used to bridge the gap between having to pay for a new property and receiving the proceeds from the sale of an existing one or to bridge the gap between a mortgage being granted and the borrower receiving an amount of cash intended for the real estate purchase. In the latter case, it is mandatory that the borrower pledges a property as security against the loan amount. In general, bridging loans do not exceed a maturity of two years and are non-renewable.

5. Calculation of the loan-to-value ratio in the case of senior liens

5.1 How should the loan-to-value ratio be calculated in the case of senior liens?

National macroprudential authorities are recommended to calculate the loan-to-value (LTV) ratio in accordance with Sections 1(2) and 1(3) of Annex IV of Recommendation ESRB/2016/14 as amended by Recommendation ESRB/2019/3.

In addition, if deemed necessary for accommodating national specificities, national macroprudential authorities can also calculate the LTV ratio in accordance with Section 1(4). However, in such cases, they are also expected to calculate it in accordance with Sections 1(2) and 1(3).

6. Value of property

6.1 How should the value of the property at loan origination be determined?

The property value at origination is the lower of the transaction value and market value of the property at loan origination. The market value may be assessed by an independent external or internal appraiser.[3] If only one value is available, this is the value that should be used.

6.2 How should the current value of the property be determined?

The current value of the property is its market value (as at the reference date), as assessed by an independent external or internal appraiser or, if such assessment is not available, as estimated using a sufficiently granular real estate value index or other statistical methods as indicated in the Recommendation. It is to be noted that Regulation (EU) No 575/2013 does not permit the use of statistical methods for determining the current value of the property.[4]

7. Prime property location

7.1 How should a prime location for property be determined?

"Property location" refers to the geographical breakdown (e.g. by regions) or to real estate submarkets, which shall also include prime and non-prime locations. For office buildings, a prime location could be a central location in a major city. For retail buildings, it may be a city centre with large pedestrian flows or a busy shopping centre. For logistics buildings, it could be a location that has the necessary infrastructure and services, as well as excellent access to transport networks.

A prime location may be determined using, for example, an empirical ex post approach. It is generally considered to be the best location in a particular market, which should also be reflected in the rental yield (typically the lowest in the market). Thus, the lowest decile of properties in terms of yield among properties transacted in a particular period may be classified as prime property. Under this approach, the prime property location should be reassessed on a regular basis.

Another way of determining a prime location is by postcode.

All in all, the reference regions for prime and non-prime locations may be defined the most efficiently by expert judgement of local experts or the sector itself.

8. Property under development

8.1 What is property under development?

The term "income-producing property under development" is used exclusively in the context of CRE financing and includes only property still being constructed which, once completed, is intended to provide its owner with income in the form of rents or profits from its sale.

The term "income-producing property under development" concerns the status of the property during its construction phase only. An essential criterion that needs to be fulfilled for a property to be classified as "income-producing property under development" is that it is intended to produce income. If a property is classified as "income-producing property under development", it is automatically included in CRE.

- The development of rented office buildings and rented business premises is to be included in "income-producing property under development" and, correspondingly, in CRE.
- The development and construction of rental housing by professional developers is to be included in "income-producing property under development" and in CRE, both during the construction phase and upon completion.
- Similarly, social housing is to be included in "income-producing property under development" and in CRE, both during the construction phase and upon completion.
- By contrast, buy-to-let housing constructed by private landlords for the purpose of letting to tenants is to be included in RRE, whether it is already in existence or under construction.
- Similarly, dwellings being constructed by natural persons (e.g. an individual) for their own use (i.e. without the intention of producing income) are not to be included in "income-producing property under development" and should always be included in RRE.

9. Income-producing real estate

9.1 How can banks – beyond the initial assessment – control whether a property is income-producing?

This depends on the local and individual practices of banks. In general, banks tend to review each loan on an annual basis as a sound credit management practice, allowing them to reconfirm the income-producing nature of the CRE.

10. Social housing

10.1 How should social housing be accounted for?

Social housing is to be included in CRE. Moreover, social housing under construction is classified as "income-producing property under development", since it is being built with the intention of producing income for its owner and should therefore be included in CRE.

A similar approach is also to be applied to loans taken out by a legal entity to fund social housing. Such a loan may be used to acquire an existing property or construct a new one and should be classified as a CRE loan.

If a natural person (e.g. an individual) purchases, for example, an apartment in a social housing property for own use, the status of this particular part of the property would change to owner-occupied RRE, and the loan taken out to fund the purchase would be an RRE loan.

11. Property for dwelling purposes

11.1 How should property for dwelling purposes constructed by a natural person (buy-to-let housing) be accounted for?

Buy-to-let housing is to be included in RRE. Furthermore, where buy-to-let housing represents a significant source of risk stemming from the domestic RRE sector, it is recommended that national macroprudential authorities monitor risks in relation to the relevant indicators separately.

11.2 How should property for dwelling purposes developed by professional developers (rental housing) be accounted for?

Rental housing is to be included in CRE. Rental housing under construction is classified as "income-producing property under development", since it is being built with the intention of producing income for its owner and should therefore be included in CRE.

A similar approach is also to be applied to loans taken out by a legal entity to fund the construction of rental housing. Such a loan taken out by a legal entity to fund the building of rental housing should be classified as a CRE loan.

If a natural person (e.g. an individual) purchases, for example, an apartment in a rental housing property for own use, the status of this particular part of the property would change to owner-occupied RRE, and the loan taken out to fund the purchase would be an RRE loan.

12. Type of financing as opposed to type of property

12.1 Is the type of property on which a loan is secured sufficient to deduce whether a loan should be a CRE loan or an RRE loan?

The type of property on which a loan is secured is important, but may not be sufficient to determine whether the loan is to be classified as CRE or RRE financing. Indeed, there are other features that are also relevant from a macroprudential perspective. The additional aspects include, but are not limited to, the type of borrower, whether or not income from rental or sale is expected in relation to the property, and whether the lending is for the private rental sector or for social housing.

This is illustrated by the following examples:

- A loan taken out by a sole proprietor (e.g. a general practitioner) for the conduct of his/her business (e.g. to renovate business premises located in his/her own house) and secured by RRE is considered to be an RRE loan.
- A loan taken out by a legal entity (e.g. a professional developer) to finance the building of residential property is considered to be a CRE loan.
- A loan taken out by a natural person (e.g. an individual) to purchase, for example, an apartment for own use is considered to be an RRE loan, as it is being extended to a natural person and is secured by RRE.

12.2 Can a natural person (e.g. an individual) be granted a CRE loan?

No. CRE loans are only extended to legal entities.

13. Valuation method for loans and debts

13.1 How are loans and debts to be valued?

The valuation principles for loans and debts require the use of nominal value and not, for example, fair value. Loans and debts are valued at the amount of principal that the debtor is contractually obliged to repay to the creditor, even where the loan or debt has been traded at a discount or premium. Loans are to be valued at less than nominal value only if they have been written off or written down as wholly or partially irrecoverable. Instruments denominated in foreign currency are to be valued as amounts in national currency converted at the market exchange rates prevailing on the reference date. The value of a loan excludes fees and any other charges. Loans must not be netted against each other or against any other assets or liabilities.

In addition, loans are to be valued on a gross basis, i.e. without regard to any provisions made against them. The same holds for allowances, even if they are not mentioned explicitly in the Recommendation. Any doubt about the debtor's ability to repay should be reflected on the balance sheet only when a loan is written down or written off.

14. Securitised and purchased loans

14.1 How should securitised loans be accounted for?

The Recommendation leaves room for discretion in the treatment of loans securitised or otherwise transferred. In this regard, it may be useful to distinguish between "synthetic" and "traditional" securitisations and other loan disposals.

In the case of a "synthetic" securitisation, the items "loans" and "debts" continue to include the portfolio of underlying loans. In a synthetic securitisation, the economic ownership of the loan is not transferred and remains on the balance sheet of the originating intermediary, which accordingly continues to be the creditor, even if the credit risk is transferred by means of credit derivatives or guarantees which, in effect, insure the originating intermediary against the default of the borrower. The originating intermediary is said to be buying protection on a reference portfolio of underlying assets, while the loan remains on its balance sheet.

In the case of a "traditional" securitisation or other loan disposal, the items "loans" and "debts" continue to include the portfolio of underlying loans when loans are not derecognised and remain on the originating intermediary's balance sheet. In a traditional securitisation or other loan disposal, the loan may be either "derecognised" or "non-derecognised". The loan is said to have been derecognised when it is removed from the balance sheet of the originating intermediary (where this is permitted by accounting and supervisory rules), and the securitisation or other loan disposal is then called a "true sale".

By contrast, the items "loans" and "debts" are computed net of the portfolio of underlying loans when loans are derecognised and are removed from the originating intermediary's balance sheet. In some circumstances, rules do not permit the loan to be removed from the originating intermediary's balance sheet, even in a traditional securitisation. In such cases, the loan transfer is said to occur without derecognition and the non-derecognised loan remains on the originating intermediary's balance sheet.

However, the information may be available through the data of financial servicers (bank or non-bank) or financial vehicle corporations (FVCs). In order to avoid double-counting in countries where this is the case, FVCs should be included in the lender type "others" insofar as they grant loans for their own account or purchase securitised loans that are no longer reported by originating lenders. Thus, in the case of traditional derecognised securitisations, information on stocks of securitised loans may still be used, while this is not the case for loans sold without securitisation.

14.2 How should purchased loans be accounted for?

In the case of loans being securitised or otherwise transferred, the items “loans” and “debts” should include purchased loans. These are to be valued at the principal amount outstanding, excluding amounts written off or written down.

15. Accounting standards

15.1 Which accounting standards are to be followed?

In accordance with the Recommendation, for the compilation of indicators, credit providers should adhere to the accounting standards applicable to them in their country of residence, which will be International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) or national generally accepted accounting principles (GAAP). Where credit providers have discretion to use several accounting standards, IFRS are generally recommended in order to facilitate cross-country comparison.

16. Accrued interest

16.1 Should accrued interest be included?

Accrued interest should be excluded from the loan to which it relates. Even when interest receivable on loans is recorded on the balance sheet as it accrues rather than when it is actually received, it should not be recorded under “loans” or “debts”.

17. Repos and reverse repos

17.1 How should repos and reverse repos be accounted for?

The items “loans” and “debts” include the components of repurchase agreements (repos) and reverse repos where these are present. The Recommendation does not require the separate identification of repo-related positions.

18. Statistical and reporting methods

18.1 Is the use of sampling allowed?

The use of sample data, both for lenders and borrowers, is possible, as long as samples are chosen with statistical criteria to assure appropriate representativeness of the domestic real estate loan market. The Recommendation requires information on real estate indicators to be sufficiently representative of the domestic real estate loan market, but leaves to national discretion whether data need to refer either to the entire population of lenders and borrowers of a country or to a sample of them. However, indicators should not refer to subsets of lenders (for example, only large credit providers) and/or borrowers (for example, only large firms) if they are not statistically and significantly representative of the local real estate market as a whole.

18.2 What is the general perimeter and scope of credit providers?

The information on real estate indicators should relate to domestic credit providers on a solo basis and should be sufficiently representative of the domestic real estate loan market. All the types of credit providers that are relevant in the particular domestic market are to be included, e.g. banks, insurance companies, pension funds and investment funds.

The information should relate to domestic credit providers on a solo basis. This includes information on branches of foreign institutions located within the domestic territory.

18.3 Which counterparty geographical location is to be considered?

There are two dimensions: (i) the location of the investor/lender, and (ii) the location of the property used as security for the loan.

Under the Recommendation, "nationality" refers to the country of incorporation of the market participant, and the nationality of investors and lenders should be broken down into at least the three following geographical categories: (i) domestic; (ii) European Economic Area; and (iii) rest of the world.

Furthermore, the indicators on both RRE and CRE financing should also include information on loans secured by property located in the domestic territory as well as abroad.

[1] Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate gaps (ESRB/2016/14) (OJ C 31, 31.1.2017, p. 1).

[2] Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 191, 28.6.2014, p. 1).

[3] For further details on the acceptable valuation methods, see Articles 208(3) and 229 of Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1) and the Q&As provided by the European Banking Authority, notably 2014_1056 and 2017_3078.

[4] Ibid.

IV. European Commission

Targeted consultation on improving the EU's macroprudential framework for the banking sector

INTRODUCTION

Background of this targeted consultation

With this targeted consultation, the European Commission wishes to consult on the EU's macroprudential framework for the banking sector in view of the legislative review mandated by Article 513 of Regulation (EU) No 575/2013, as amended by Regulation (EU) 2019/876 (hereinafter 'CRR'). The information obtained will feed into the impact assessment for a possible legislative proposal.

The Commission is interested in evidence and substantiated views from a wide range of stakeholders. Contributions are particularly sought from non-governmental organisations representing notably users of financial services, think tanks and academics, national regulators and supervisors, banks and other financial institutions, and EU institutions.

Context and scope of the targeted consultation

The Commission is launching this targeted consultation to gather evidence in the form of relevant stakeholders' views and experience with the current macroprudential rules for banks in line with the better regulation principles and in view of the forthcoming legislative review mandated by Article 513 CRR.

Article 513 CRR requires the Commission to complete a review of the macroprudential provisions in CRR and in Directive 2013/36/EU (hereinafter 'CRD') by June 2022 and, if appropriate, to submit a legislative proposal to the European Parliament and to the Council by December 2022.

Macroprudential policy is the use of primarily prudential tools to limit systemic risk and safeguard financial stability. Systemic risk refers to the risk of a widespread disruption to the provision of financial services caused by an impairment of the financial system or parts of it, and which can have serious negative consequences for the real economy. Macroprudential policy complements microprudential policy, which focuses on the soundness of individual financial institutions. By providing a systemic perspective, it aims to correct externalities that are not tackled by microprudential supervisors who address risks at the level of a single institution. It has clearly defined financial stability objectives, specific instruments and dedicated institutions. Macroprudential policy has been established in the wake of the 2008 Global Financial Crisis.

The macroprudential toolkit for credit institutions (referred to as 'banks' in the remainder of this document), introduced in the Capital Requirements Regulation and Directive (CRR/CRD), is applicable since 2014. The macroprudential framework implements and expands international standards agreed by the Basel Committee on Banking Supervision (BCBS). The main tools are capital buffers, i.e. Common equity Tier 1 (CET1) capital requirements on top of minimum (Pillar 1) and additional (Pillar 2) capital requirements. Capital buffers hence reduce the risk that unexpected losses will result in banks breaching their minimum and additional capital requirements.

The mandate in Article 513 CRR offers the opportunity to review and improve the EU macroprudential provisions applicable to banks. Article 513 CRR envisages a broad scope for the review, requiring the Commission to assess the effectiveness, efficiency and transparency of the macroprudential framework, and listing a number of specific issues to be considered in view of a possible legislative proposal. These issues must be analysed taking into account ongoing discussions at the international level. It is also necessary to take into account the Covid-19 crisis experience, the first time many macroprudential instruments were utilised during a crisis. The Covid-19 shock affected banks' balance sheets far less than typical stress test scenarios, thanks (in part) to the swift and determined fiscal and monetary policy responses to the pandemic, the progress made over the past decade in strengthening the (micro and macro) prudential requirements for banks and the progress made in setting up the Banking Union. However, the crisis did highlight some important macroprudential issues that have been subject to international debate, such as the releasability of buffers and banks' willingness to use them during a crisis. While, the full lessons and consequences of the Covid-19 crisis are still uncertain, the macroprudential review provides a good opportunity to start addressing any gaps or weaknesses in the current framework and reflect on ways to make macroprudential policy more effective in the post-pandemic period and beyond.

The review of the macroprudential provisions in CRR and CRD pursues goals that are distinct from those of the banking package proposed by the Commission on 27 October 2021 to finalise the implementation of the Basel III agreement in the EU. This consultation is being launched after the publication of the banking package proposal, allowing respondents to take into account the likely implications of the package for the macroprudential framework in banking, and in particular the Output Floor, which sets a lower limit ("floor") on the capital requirements ("output") that banks calculate when using their internal models.

Responding to this consultation and follow-up

The Commission has decided to launch a targeted consultation designed to gather evidence on improving on the EU macroprudential framework for the banking sector.

The targeted consultation is divided into four sections:

- Section 1: Overall design and functioning of the buffer framework (Questions 1-4)
- Section 2: Missing or obsolete instruments, reducing complexity (Questions 5-8)
- Section 3: Internal market considerations (Questions 9-13)
- Section 4: Global and emerging risks (Questions 14-16)

Each question focuses on a particular aspect of the macroprudential framework. Respondents are invited to indicate the extent to which they consider that change is necessary regarding this particular aspect and to present their reasoning, as far as possible supported by evidence. If the space for responding is not sufficient, respondents may use links or upload background documents with the required evidence. Respondents are also invited to raise any general or specific observations they have on improving the EU macroprudential framework for banks which were not covered in other sections (Question 17).

The targeted consultation is available in English only and will be open until 18 March 2022.

CONSULTATION QUESTIONS

1. OVERALL DESIGN AND FUNCTIONING OF THE BUFFER FRAMEWORK

The comprehensive macroprudential toolkit for banks, introduced following the Global Financial Crisis, is applicable since 2014. The macroprudential framework implements, and expands on international standards agreed by the BCBS. The main tools are capital buffers, i.e. additional Common equity Tier 1 (CET1) capital requirements on top of the Pillar 1 and Pillar 2 requirements that banks need to fulfil to remain a going concern. Capital buffers hence reduce the risk that unexpected losses will result in banks having to be declared failing or likely to fail. They enable banks to absorb losses while maintaining the provision of key services to the economy.

The CRD sets out five capital buffers, which together form the combined buffer requirement (CBR). Four buffers are based on the Basel agreements, while one is EU-specific. The four Basel-defined buffers are:

- capital conservation buffer (CCoB, Art 129 CRD), which is calibrated at 2.5% of the total amount of assets adjusted by the riskiness of these assets (Risk Weighted Assets, RWA), to ensure that banks have an additional layer of usable capital that can be drawn down when losses are incurred;
- countercyclical capital buffer (CCyB, Art 130 CRD), which aims to protect the banking sector from periods of excess aggregate credit growth that have often been associated with the build-up of system-wide risks;
- global systemically important institutions (G-SII) buffer (Art 131 CRD), which aims to reduce the probability of failure of a global systemically important bank by increasing their going-concern loss absorbency capital requirement;
- other systemically important institutions (O-SII) buffer (Art 131 CRD), which aims to reduce the probability of failure of banks that are deemed systemically important at the national level by increasing their going-concern loss absorbency capital requirement.

The EU-specific buffer is the systemic risk buffer (Art 133 CRD), which can be used to address a broad range of systemic risks, which may also stem from exposures to specific sectors, as long as they are not already addressed by the other buffers above.

Each bank has to meet a specific CBR. Unlike a breach of minimum capital requirements, breaching the CBR does not prevent banks from operating as a going concern, but banks breaching their CBR have to restrict distributions in the form of dividends, share buy-backs, coupon payments on additional Tier 1 (AT1) instruments, and discretionary bonus payments, and they will have to submit a capital conservation plan to supervisors.

When faced with a shock, buffers should avoid excessive deleveraging by banks, which could amplify the initial shock to the economy. In the Covid-19 crisis (the first crisis with a macroprudential framework in place), banks have indirectly benefited from unprecedented public support measures to their household and corporate customers; therefore, the shock-absorbing feature of capital buffers has not been tested.

The crisis has triggered a discussion on whether the capital buffer framework is optimally designed not only to provide additional resilience, but also to act counter-cyclically when necessary, including by encouraging banks to maintain their supply of credit during an economic downturn. The review of the macroprudential framework should therefore focus on the best use of buffers in a crisis, covering various aspects:

- Stigma related to Maximum Distributable Amount (MDA) restrictions: Using capital buffers during a crisis (i.e. breaching the combined buffer requirement (CBR)) does not prevent banks from continuing to operate as a going concern, unlike a breach of Pillar 1 minimum capital requirements. However, when operating below their CBR, banks face automatic and graduated (depending on the buffer shortfall) restrictions on distributions, including dividends, bonus payments and coupon payments on Additional Tier 1 instruments. While these payout restrictions are designed to prevent imprudent depletion of capital, they may also incentivise banks to deleverage to avoid such restrictions and market stigma.

- Capital buffer usability: Unlike minimum requirements, capital buffers that have been built-up can in principle be drawn down or released when losses have to be absorbed during times of stress. Capital buffers are only fully usable if they can be depleted without breaching parallel minimum requirements, i.e. the Leverage Ratio (LR) and the Minimum Requirement for own funds and Eligible Liabilities (MREL), including the MREL subordination requirement for certain banks. In practice, parallel prudential and resolution minimum requirements may become binding before capital buffers are fully used and hence may limit banks' ability to sustain lending in situations of economic distress. However, it is also important to bear in mind that the leverage ratio is precisely intended to prevent banks from becoming excessively leveraged. Moreover, reducing overlaps between buffers and other requirements may not be possible without implications for the calibration of overall capital requirements and of requirements in the resolution framework (Bank Recovery and Resolution Directive (BRRD), Single Resolution Mechanism Regulation (SRMR)).

- Balance between structural and releasable buffers: In response to the Covid-19 crisis, responsible authorities reduced and relaxed capital requirements for banks (notably certain buffers) and Pillar-2 Guidance to enhance their lending capacity in the face of a steep rise in liquidity needs of households and businesses. The scope for capital releases from macroprudential buffers was quite limited, though, as only one macroprudential buffer, the CCyB, is explicitly designed to be released in a crisis. The bulk of the capital buffers (i.e. CCoB, G-SII and O-SII buffers and, to a lesser extent, SyRBs) are of a structural nature and should be in place at all times or for as long as a particular type of risk is present. As there are concerns that banks might prefer to deleverage rather than allow their capital to fall below the CBR, there are calls for making a larger share of buffers releasable in a crisis. One option that is being widely discussed is a positive neutral CCyB rate, i.e. a CCyB calibration that would be above zero even in the absence of a credit boom. A key question in that regard is whether a positive CCyB rate over the cycle should (and could) be achieved without an increase in the overall level of capital requirements.

- Procyclicality in risk weights: Capital buffer requirements are expressed in percentages of risk-weighted assets, so the amount of capital needed to meet a given combined buffer requirement depends on the level of risk weights. This is an issue for banks using internal models to calculate risk weights for their various exposures, but it may also affect banks using the standardised approach to the extent that they rely on external ratings. Rising credit losses caused by an economic shock may drive up risk weights (or lower external ratings), increasing the amount of risk-weighted assets held by banks and, hence, the amount of capital they need to meet their buffer requirements, which are expressed as percentages of risk-weighted assets. This phenomenon has not been observed in the current crisis as public support measures have kept loan defaults at a low level. However, in a different crisis with rapidly rising loan defaults, rising risk weights could accelerate the depletion of capital buffers and cause banks to behave pro-cyclically. This could also be an important aspect of how the buffer framework operates in a crisis, although the impact of risk weight variations over the cycle can be expected to be mitigated by the Output Floor.

- Banks' willingness to use their buffers will also depend on their expectations as regards the restoration and replenishment of buffers after a shock. They will be more reluctant to lend if they know that their capital requirements will quickly increase. This depends on how MDA restrictions and capital conservation rules as laid down in Art. 141 to 142 CRD are applied and how soon released/reduced buffers are restored to their previous levels.

Apart from the operation of the buffer framework over the cycle, its suitability for dealing with structural risks should also be reviewed. Particular attention should be given to the appropriateness of capital buffers for systemically important institutions, global (G-SIIs) and other (O-SIIs). Together, these institutions are the main providers of credit to households and firms in Member States and, as such, vital to economic performance. At the same time, the integration of G-SIIs and O-SIIs in increasingly complex financial systems makes them vulnerable to financial shocks occurring outside the banking sector and may create potential contagion channels for financial instability (see section 4 for the global contagion risks). In addition to specific buffer requirements (G-SII buffer), G-SIIs have to comply with tighter limits on their leverage ratio, the leverage ratio buffer. Such a leverage ratio buffer requirement does not exist for O-SIIs. Art. 513(e) CRR requires the Commission to consider whether the leverage ratio buffer requirement should also apply to O-SIIs.

Another primarily structural buffer is the SyRB. Its use has been made much more flexible recently (through the 2019 amendments to CRD, which became applicable at the end of 2020), allowing its application to sectoral exposures (or subsets thereof); at the same time, the restriction to apply it only to structural risks was removed. SyRBs, in particular sectoral SyRBs, are not yet widely used. They have been considered as a possible substitute for risk weight measures in accordance with Art. 458 CRR, which exist in several Member States. The calibration of a sectoral SyRB would have to be very high to address macroprudential risks that are not fully reflected in risk weights, as those low risk weights would also imply lower capital requirements for a given buffer rate. High calibrations would also imply more complex authorization procedures.

Having several different types of buffers introduces a degree of complexity in the macroprudential framework. This complexity may be unavoidable in the EU in view of (i) the flexibility that is needed to address a wide range of different systemic risks across different Member States, and, (ii) the existing decentralised governance of the EU macroprudential framework in banking.

However, it may be useful to consider whether this complexity could be reduced or whether clearer guidance would be needed to ensure a consistent use of the buffer framework across Member States.

1.1. ASSESSMENT OF THE BUFFER FRAMEWORK

Question 1: Has the capital buffer framework been effective so far in providing sufficient resilience against all types of systemic risks in Member States and for different types of banks and exposures?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 1, considering not only overall resilience, but also the interactions of the individual components of the capital buffer framework (i.e. CCoB, CCyB, G-SII, O-SII and SyRB buffers); is it sufficiently clear which buffer is to be used to address which risk?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 2: Has the capital buffer framework been effective in dampening financial or economic cycles in Member States?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 2, considering in particular the experience to date with the calibration of buffers during phases of economic growth and rising vulnerabilities, and the use of buffers after an economic/financial shock; do you see any impediments to the intended use of buffers both during upswing and downswing phases?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 3: How well is the systemic importance of banks addressed by G-SII and O-SII capital buffer requirements?

(1 = very poorly, 5 = very well)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 3, considering in particular whether G-SII and O-SII buffer requirements are appropriate and coherent, also across countries, in view of their market shares, activities, market conditions, advances in setting up the Banking Union, and the risk their failure would pose to financial stability.

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

1.2. POSSIBLE IMPROVEMENTS OF THE BUFFER FRAMEWORK

Question 4: What changes would improve the current buffer framework and what would be, in your view, the pros and cons of these changes?

Question 4.1. Enhanced clarity of the buffer framework: Consider whether there is scope for simplifying/streamlining the buffer framework or providing better guidance on how to use it.

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 4.2. Releasable buffers: Consider in particular whether an increase of releasable buffers could be achieved in a capital-neutral way over the cycle, the circumstances and conditions under which buffers should be released and what coordination/governance arrangements should be in place.

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 4.3. Buffer management after a capital depletion: How can capital buffers be restored/replenished after an adverse shock in such a way that banks will provide sufficient lending in the recovery? In that regard, is there scope for optimising the MDA restrictions and capital conservation rules as laid down in Articles 141 to 142 CRD?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 4.4. Overlap between capital buffers and minimum requirements: How important is it to reduce the overlap between capital buffers and other requirements, and how could this be achieved without unduly raising overall capital requirements and having to re-open the composition of the leverage-ratio based "capital stack" and the calibration of the MREL based on the total exposure measure and the MREL subordination requirement?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 4.5. Consistent treatment of G-SIIs and O-SIIs within and across countries: Should there be more EU-level guidance or binding rules on the identification of O-SIIs and the calibration of O-SII buffers? Should the leverage ratio buffer requirement for G-SIIs also apply to O-SIIs?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 4.6. Application of the SyRB to sectoral exposures: Are the thresholds for opinions and authorisations appropriate for sectoral SyRB rates (and for the sum of G/O-SII and SyRB rates)? Should the combined SyRB rate be calculated as a percentage of total risk exposure amounts and not sectoral risk exposure amounts? How should sectoral risk exposure amounts be calculated after the introduction of the output floor?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

2. MISSING OR OBSOLETE INSTRUMENTS, REDUCING COMPLEXITY

The EU has a broad and complex range of macroprudential tools. One of the questions to be assessed in the review is whether certain existing tools have become obsolete, whether some need to be strengthened and whether certain tools are missing. The scope for reducing unwarranted complexity should also be explored.

The Commission is required to assess in particular whether Borrower-Based Measures (BBM) should be added to the EU macroprudential toolkit to complement capital-based instruments and to allow for the harmonised use of these instruments in the internal market, assessing also whether harmonised definitions of those instruments and the reporting of respective data at Union level are a prerequisite for the introduction of such instruments (Article 513(1)(d) CRR). BBM could complement the existing toolset to address and mitigate systemic risks, especially those related to real estate, and to prevent the potential negative spill-overs to the broader financial system and the economy. While several Member States are already using BBM based on national law, a complete set of BBM 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, where this is necessary to ensure the effectiveness of BBM in the internal market.

The review should also seek to identify instruments that may be obsolete. The finalisation of the Basel III reforms and the introduction of an output floor has implications for macroprudential instruments that directly or indirectly affect risk weights such as those provided under Articles 124, 164 and 458 CRR, which concern exposures secured by mortgages. Furthermore, having multiple prudential tools that can target similar risks creates unwarranted complexity and may contribute to a more fragmented internal market. The powers to set floors for, or raise, certain risk weights and parameters (as set out in Articles 124 and 164 CRR) have not been widely used since their introduction in the EU framework. In particular, Article 164 CRR has never been used by an EU Member States. Some of the shortcomings of the two articles have been addressed in CRRII, with the aim of improving their usability. While the very short time span since the improved articles have been applicable does not allow to conclude on their actual usability, it does make sense to reassess their suitability in view of the introduction of the output floor with the finalisation of the Basel III reforms.

With Article 458 CRR, the CRR and CRD package contains a last-resort measure to flexibly address a number of systemic risks that cannot be adequately and effectively addressed by other macroprudential tools in the package. The use of the tool is subject to various safeguards, aimed at avoiding that such measures create disproportionate obstacles to the functioning of the internal market. During the past years, Article 458 CRR has been used by some Member States to adjust risk weights for exposures to residential real estate markets. The need for such measures may diminish, given that the SyRB can be used for sectoral exposures and due to the phasing-in of the output floor.

Article 459 CRR empowers the Commission under very restrictive conditions to impose stricter prudential requirements for a period of one year in response to changes in the intensity of micro- or macroprudential risks. However, scenarios where the conditions for using this article would be met are very unlikely. Moreover, the Article could become more symmetric and allow for the temporary relaxation of certain requirements, notably to support the recovery after an adverse shock.

One measure that could have made sense in the context of the Covid crisis would be the temporary imposition of system-wide restrictions on the distribution of capital to investors and staff in the face of exceptional uncertainty. However, such a measure would not have been covered by Article 459. During the Covid-19 pandemic, authorities in the EU asked banks to refrain from capital distributions, through dividends, share repurchases and bonuses, to ensure the stability and resilience of the banking system and to support the flow of credit to the real economy. Those recommendations aimed at retaining capital in the banking system, including capital released from buffers and from Pillar 2. The recommendations were observed by banks. EU legislation currently only allows supervisors to impose legally binding distribution restrictions on banks on a case-by-case basis but does not provide for legally binding supervisory powers to temporarily prohibit distributions on a system-wide basis under exceptional circumstances. Microprudential supervisors consider that they had sufficient powers to enforce the recommendation on distribution restrictions in the Covid-19 crisis. However, in the context of the macroprudential review, the role of macroprudential authorities in imposing restrictions on distributions in exceptional circumstances should also be considered, as well as their coordination at the European level.

2.1. ASSESSMENT OF THE CURRENT MACROPRUDENTIAL TOOLKIT AND ITS USE

Question 5: Based on the experience so far, have you observed any major gaps in the EU macroprudential toolkit (also beyond the buffer framework)?

(1 = major gaps, 5 = fully comprehensive)

1 2 3 4 5 Don’t know/no opinion

Please explain your answer to question 5, indicating which gaps you perceived and what consequences these gaps have or might have had:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 6: Has the experience with the macroprudential toolkit so far revealed any redundant instruments or instruments that need to be redesigned to make them fit for purpose?

Yes No Don’t know/no opinion

Please explain your answer to question 6, specifying which instruments could be redundant or would need to be redesigned, as well as the expected benefits thereof:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 7: How effective has the macroprudential toolkit and EU governance framework been in managing a crisis?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don’t know/no opinion

Please explain your answer to question 7, notably in light of the experience gained during the Covid-19 crisis:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

2.2. POSSIBLE IMPROVEMENTS OF THE BUFFER FRAMEWORK

Question 8: What changes to the current set of instruments would improve the macroprudential toolkit and what would be, in your view, the pros and cons of these changes?

Question 8.1. Borrower-based measures: Should all Member States have a common minimum set of borrower-based measures to target more directly potentially unsustainable borrowing by households and corporates, particularly in a low-interest-rate environment? Which tools should Member States have and what role should EU bodies play in fostering their effective use?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 8.2. System-wide distributions restrictions: Should EU and/or national authorities have the power to restrict distributions for the entire banking system to conserve capital in a severe crisis situation? Under which conditions and how should such system-wide restrictions be used, taking also into account the role of European bodies?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 8.3. Temporary relaxation of prudential requirements to support the recovery after a shock: Should EU and/or national authorities have more powers to relax prudential requirements after banks have suffered a shock, to avoid pro-cyclical behaviour and enhance banks’ capacity to support the recovery? What elements of the prudential framework could be addressed using such powers (e.g. unwarranted risk weight hikes after a shock)? Could Art. 459 CRR be adapted for this purpose?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 8.4. Instruments targeting risk weights and internal model parameters: How will the forthcoming application of the input and output floors under the Basel III agreements affect the need for tools that adjust risk weights or the parameters of internal models (Art. 124, 164 and 458 CRR)? Are such tools still necessary and, if yes, how should they be adapted to the new regulatory environment?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

3. INTERNAL MARKET CONSIDERATIONS

The EU macroprudential framework also seeks to preserve the integrity of the internal market while leaving it mostly to Member State authorities to adequately address systemic risks, which tend to be specific to individual Member States (although this may change with deeper economic and financial integration). The largely decentralised use of macroprudential instruments is therefore framed by provisions in CRR and CRD, which require an EU-level surveillance and, in some cases, authorisations for measures that could create obstacles to the functioning of the internal market. The complexity of procedures and of the interactions between different instruments may, however, prevent authorities from making an effective use of the instrument and possibly cause an inaction bias, especially in the case of sectoral SyRBs that may need to be calibrated at very high rates to be effective.

Moreover, the effectiveness of national macroprudential measures in the internal market depends on being able to prevent, through reciprocation by other Member States, circumvention and regulatory arbitrage. This issue may arise not only in relation to other Member States, but possibly also for other parts of the financial sector to the extent that they can provide similar services as banks. It is important to assess, also in light of the recent crisis experience, whether the current framework offers not only the appropriate macroprudential tools to national authorities, but also ensures their effectiveness in the internal market, and whether it provides for adequate safeguards for the integrity of the internal market and avoids market fragmentation especially within the Banking Union. The review should therefore also consider whether provisions related to the internal market achieve their goals, and whether they do so without undue complexity or whether there is scope for simplifying and streamlining procedures while maintaining necessary safeguards.

Art. 513(1)(f) CRR requires an assessment as to whether the current voluntary reciprocation of certain macroprudential measures should be made mandatory and whether the current ESRB framework for voluntary reciprocity is an appropriate basis for that. Reciprocity is currently voluntary for a CCyB above 2.5%, SyRBs and measures taken under Article 458 CRR.

3.1 ASSESSMENT OF THE CURRENT MACROPRUDENTIAL FRAMEWORK'S FUNCTIONING IN THE INTERNAL MARKET

Question 9: Are macroprudential measures as used by national authorities generally commensurate with systemic risks in a given country, or do you consider that there are unjustified disparities across countries?

(1 = highly disparate, 5 = fully commensurate)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 9, providing supportive evidence on possible disparities and their likely impact on the internal market:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 10: Has the oversight of national macroprudential policies through notification, assessment and authorisation procedures been proportionate and effective in preventing an excessive use of macroprudential tools and undue market fragmentation?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 10, taking also into account the complexity of procedures and related administrative burdens for authorities and the industry and whether you see scope for streamlining and simplifying the procedures, while retaining necessary safeguards:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 11: Have the provisions on reciprocation been effective in maintaining a level playing field in the banking sector and preventing the circumvention of national macroprudential measures through regulatory arbitrage?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 11, indicating notably whether you would see merit in extending the mandatory reciprocation framework to the instruments not currently covered by it:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 12: Has the current allocation of responsibilities for macroprudential policy between the national and European level been effective in ensuring that sufficient and appropriate action is taken to limit systemic risks and manage crises?

(1 = highly ineffective, 5 = highly effective)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 12, taking notably into account the roles of the ESRB, the ECB and the Commission (which may impose stricter prudential requirements in accordance with Article 459):

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

3.2 POSSIBLE IMPROVEMENTS RELATING TO THE FUNCTIONING OF THE MACROPRUDENTIAL FRAMEWORK IN THE INTERNAL MARKET

Question 13: What changes to the current governance arrangements and oversight procedures would improve the compatibility of macroprudential policy making with the internal market, and how could the complexity of procedures be reduced?

Question 13.1 Monitoring of the macroprudential stance: Should there be regular overall assessments of the macroprudential requirements (or stance) in each Member State in addition to, or as a substitute of, the EU-level monitoring and vetting of individual macroprudential measures? What measures should be available to which bodies in case the national macroprudential stance is deemed disproportionate to the level of risk (too low or too high)?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 13.2 Reciprocation of national macroprudential measures: Should there be mandatory reciprocation for a wider range of macroprudential measures and how could this be implemented (role of the ESRB, materiality thresholds, etc.)?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

4. GLOBAL AND EMERGING RISKS

Financial stability in the EU does not only depend on limiting systemic risks and vulnerabilities within the EU banking sector. There are contagion risks originating outside the EU, possibly involving non-bank financial intermediation, that also need to be addressed. While financial intermediation through non-banks is growing in importance, banks continue to play a pivotal role in the global financial system. Large banks provide crucial services for non-bank financial intermediaries. At the same time, some increasingly significant developments, and in particular cyber security breaches, the entry of big tech firms into financial services and crypto assets, all take place at a global scale and can represent growing threats to financial stability. Also, the Covid-19 crisis has shown how events originating outside the financial sector can affect financial stability. In the future, climate risks are likely to materialise more suddenly, more frequently, more severely and with greater cross-border implications. In the recent consultation on the Renewed Sustainable Finance Strategy, most respondents highlighted the importance of having a robust macroprudential framework that incorporates climate risks. The suitability of the existing macroprudential toolkit will have to be assessed in view of the above-mentioned global risks.

Exposures to third countries can also represent a threat to financial stability. Articles 138 and 139 CRD foresee powers to address risks arising from excessive credit growth in third countries and to ensure a coherent approach for the buffer setting for third country exposures. These powers have never been used since their introduction in the EU framework, raising the question whether these provisions represent the most appropriate way of dealing with systemic risks stemming from third countries.

From a financial stability perspective, a growing non-bank financial sector brings benefits in terms of increased risk-sharing across the financial system, but it can also result in new risks and vulnerabilities. In particular, the expansion of the non-bank financial sector in recent years has been accompanied by an increase in the riskiness of some asset portfolios, rising liquidity transformation and increased leverage. Such risk-taking has created vulnerabilities which need to be monitored and assessed, taking into account interconnectedness within the financial system and the banking sector in particular, as well as the role of non-bank financial institutions in funding the real economy more broadly. Art 513(1)(g) CRR mandates the Commission to consider tools to address new emerging systemic risks arising from banks' exposures to the non-banking sector, in particular from derivatives and securities financing transactions markets, the asset management sector and the insurance sector.

The banking sector is exposed to growing cyber-threats, and its reliance on critical infrastructure offered by third-party providers may create new vulnerabilities. Financial stability can be disrupted when cyber incidents spread across banks through their financial and information technology connections, as well as their common dependence third-party service providers.

Finally, crypto-assets are a new, rapidly expanding but high-risk and largely unregulated asset class that also spawns a large industry of service providers. Banks can become exposed to crypto-assets through an increasing variety of channels, direct and indirect, financial or operational. It should therefore also be assessed whether adjustments to the macroprudential framework are needed in response to the rise of the crypto economy.

4.1 ASSESSMENT OF THE CURRENT MACROPRUDENTIAL FRAMEWORK'S SUITABILITY FOR ADDRESSING CROSS-BORDER AND CROSS-SECTORAL RISKS

Question 14: Have macroprudential tools been appropriate and sufficient to limit the systemic risk arising from EU banks' exposures to third countries?

(1 = not at all appropriate and sufficient, 5 = fully appropriate and sufficient)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 14, also in light of the experience gathered so far, considering in particular whether the EU's existing macroprudential tools and capital requirements (notably Articles 138 and 139 CRD) are sufficient to limit systemic risks emanating from EU banks' third country exposures:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 15: Is the EU macroprudential toolkit adequate for monitoring and mitigating banks' systemic risks related to global market-based finance, securities and derivatives trading as well as exposures to other financial institutions?

(1 = not at all adequate, 5 = fully adequate)

1 2 3 4 5 Don't know/no opinion

Please explain your answer to question 15 in light of the experience gathered so far, identifying in particular gaps related to derivatives, margin debt and securities financing transactions:

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

4.2. POSSIBLE ENHANCEMENTS OF THE CAPACITY OF THE MACROPRUDENTIAL FRAMEWORK TO RESPOND TO NEW GLOBAL CHALLENGES

Question 16: How do you expect systemic risks to evolve over the coming years and what enhancements of the EU macroprudential monitoring framework and toolkit (notably capital buffers, rules on risk weights and exposure limits), would be necessary to address global threats to financial stability?

Question 16.1. Financial innovation: What risks to financial stability could result from banks' new competitors (FinTech and BigTech) and the arrival of new products (notably crypto-based)? Is there a need to enhance banks' resilience in view of such changes? If so, how could this be achieved while maintaining a level playing field?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 16.2. Cybersecurity: Is there a need to enhance the macroprudential framework to deal with systemic cybersecurity threats? If not, how should the existing tools be used to mitigate threats and/or build resilience?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 16.3 Climate risks: Should the macroprudential toolkit evolve to ensure its effectiveness in limiting systemic risks arising from climate transition and from physical climate change, also considering the current degree of methodological and data uncertainty? And if so, how?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

Question 16.4. Other ESG risks: Should the macroprudential toolkit further evolve to address financial stability risks stemming from unsustainable developments in the broader environmental, social and governance spheres? How could macroprudential tools be designed and used for this purpose?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

OTHER OBSERVATIONS

Please indicate any other issues that you consider relevant in the context of review of the macroprudential framework. You may also use this section to express your views on priorities and the desirable overall outcome of the review.

Question 17: Do you have any general observations or specific observations on issues not covered in the previous sections?

5000 character(s) maximum including spaces and line breaks, i.e. stricter than the MS Word characters counting method.

V. European Commission

Feedback statement of the targeted consultation on improving the EU's macroprudential framework for the banking sector

Feedback statement of the targeted consultation on improving the EU's macroprudential framework for the banking sector

Objective of the targeted consultation

The objective of the targeted consultation was to gather the views of relevant stakeholders views on, and their experience with the EU's macroprudential rules for banks. The targeted consultation is part of the Commission's ongoing legislative review of the macroprudential framework as mandated by Article 513 of Regulation (EU) No 575/2013, as amended by Regulation (EU) 2019/876 ('CRR'). The information provided by stakeholders will contribute to an evaluation and an impact assessment for a possible legislative proposal that will be submitted to the European Parliament and to the Council possibly in the first half of 2023. It complements the responses to a call for advice that had been addressed by the Commission to the ESRB, the EBA and the ECB.

The macroprudential toolkit for banks has been applicable since 2014. It refers primarily to a set of prudential tools designed to limit systemic risks and safeguard financial stability. Systemic risks refers to the risks of disruption to financial services caused by a significant impairment of all or parts of the Union's financial system that have the potential to have serious negative consequences for the internal market and the real economy.[1]

Article 513 CRR envisages a broad scope for the review, requiring the Commission to assess the effectiveness, efficiency, and transparency of the macroprudential framework overall, and to consider a number of specific issues in view of a possible legislative proposal. These issues must be analysed considering ongoing discussions at the international level, in particular in the Basel Committee on Banking Supervision (BCBS). It is also necessary to take into account the COVID-19 crisis experience, which has been the first time many macroprudential instruments were utilised during a crisis, internal market considerations, and emerging systemic risks such as climate change and cybersecurity.

The questions in this online consultation covered four thematic areas:

1. The buffer framework
2. Missing or obsolete instruments and scope for reducing complexity
3. Internal market considerations
4. Global and emerging risks

There were both multiple-choice and open-ended questions in the consultation, inviting respondents to assess how the framework has operated so far and to make proposals for its improvement. Respondents could contribute to all or some of the sections or questions, and they had the possibility to submit additional papers/material. Not all respondents replied to all questions, so the total number of respondents varies between and within sections. For this reason, for each question, the percentages indicated are always the share of the actual respondents (which also includes those who answered 'don't know'). For the open-ended questions the number of responses, or an indication of the broad sentiment, is presented where it was possible to group similar opinions.

Who replied to the consultation?

The consultation targeted all interested stakeholders from the public and private sectors, including finance ministries, central banks, macroprudential authorities, financial regulators, banks, other commercial and non-commercial organisations, experts, academics and citizens.

In total, 51 contributions were received, of which 22 were from public authorities (regulators, central banks, ministries), 28 from companies or business organisations and one response was from a nongovernmental organisation.

Amongst the 28 companies / business organisations, about one-third was from banks. Overall, about 94% of the replies came from within the EU-27 and EEA. There was a wide geographical coverage with 20 countries represented.

19 papers were submitted, either in addition to questionnaire answers or as stand-alone contributions. These papers have been analysed and have been considered together with the statistical analysis of the multiple-choice questions and replies to the open-ended questions in the summary provided below.

10 respondents asked to remain anonymous. All the responses are published on the targeted consultation webpage.

Main findings

Responses to the consultation brought to light a number of issues that can be summarised under three headings: (i) buffer usability, (ii) consistency in the use of macroprudential toolsand streamlined oversight, and (iii) missing or obsolete instruments.

Section 1: Buffer usability

Ensuring that banks are able and willing to use capital buffers to support lending and absorb losses in a crisis was one key issue raised in the responses and attracted most of the attention by respondents in their written interventions to the open-ended questions. The COVID-19 experience brought the issue of buffer usability to the fore and triggered a discussion about whether the capital buffer framework is optimally designed not only to provide sufficient resilience, but also to act counter-cyclically when necessary, allowing banks to maintain their supply of credit after an economic shock.

More than twice the number of respondents (around 48%) felt that the capital buffers had been effective/highly effective in providing sufficient resilience against systemic risks (by ensuring that banks were sufficiently capitalised) than those who viewed the framework has been ineffective/ highly ineffective (around 22%).

By contrast, only about a fifth of respondents believed that the framework had been effective/ highly effective in its (secondary) "counter-cyclical" role, i.e. smoothening financial cycles (reducing peaks and troughs), particularly through the release of buffer requirements during a crisis to stimulate creditsupply, or addressing systemic shocks that emanate from risks that go beyond the build-up of domestic financial cycle imbalances, e.g. due to geopolitical or health crises. The limited build-up of releasable buffers before the COVID-19 crisis was identified as hampering the ability of macroprudential authorities to respond to disruptive systemic shocks by most respondents. 19 respondents argued that the existing balance between structural and releasable buffers may need to be reconsidered given that releasable buffers were limited in size.

It was mentioned in several responses that banks may be reluctant to dip into their buffers, notably due to potential stigma effects linked to the restrictions on pay-out distributions or maximum distributable amount (MDA) that apply when banks fall below their combined buffer requirement. In this sense, the combined buffer requirement may act like a hard capital requirement that banks will aim to avoid breaching at all costs. Ten responses argued that targeted changes to MDA rules could help lessen this issue. Another factor that could explain banks' reluctance to use their capital held in buffers or released from buffers may be the lack of guidance and transparency as regards the replenishment pathway of buffers and the uncertainty about possible supervisory actions, an issue that was discussed in 12 responses.

Banks may also be prevented from using their buffers because of overlaps between different prudential and resolution requirements. 20 respondents to the consultation argued that overlaps between capital buffers and minimum requirements (Leverage Ratio (LR) and TLAC/MREL in particular) may constrain the usability of buffers. The interaction between (micro- and macro-) prudential and resolution frameworks is mentioned more generally as an issue that would require further attention. Indeed, several respondents to the consultation highlighted the lack of coordination between authorities, that can result in conflicting policy measures or double counting (e.g., for instance, some respondents mentioned the potential overlap between Pillar 2 requirements and Pillar 2 guidance calibrations, on one hand, and some macroprudential buffers on the other).

Different options for fostering a shift towards more releasable buffers have been mentioned in the Mresponses to the targeted consultation. There was no consensus on whether the increase in macroprudential space should be achieved in a capital neutral way or through a net increase in overall capital buffer requirements. A variety of proposals were made:

- Allowing for a more (pro-)active and timely use of the CCyB: the credit-to-GDP gap as the main quantitative indicator for the buffer guide may not have been effective in addressing credit imbalances in a timely manner, as other indicators seem to have better early-warning properties. This would allow for a more (pro-)active and timely use. Moreover, the current timeframe for rate setting and releases (i.e., quarterly setting and 12-month lead) is considered too rigid and not fit for purpose.
- Allowing, recommending or requiring a positive neutral rate of the countercyclical capital buffer (CCyB) or a core systemic risk buffer (SyRB) rate, with or without adjustment to other prudential requirements to be held in the steady state to enhance the overall share of capital held in releasable buffers and thus the overall macroprudential space available.
- Releasability of the CCoB: Making the capital conservation buffer (CCoB) partially or fully releasable in exceptional circumstances and under strict conditions.

- Governance issues: Respondents to the consultation supported greater transparency around the use of buffers.
- More information about the timing of buffer releases and replenishment paths: Better coordination between micro- macro-prudential authorities and EU institutions.
- Overlapping requirements: Several respondents argued that the leverage ratio and MREL could present material obstacles to buffer usability, but that further analysis would be necessary before considering mitigation options. While extending the G-SII leverage ratio buffer to O-SIIs could reduce overlaps for some banks, most respondents do not consider such a measure appropriate at the current juncture.

Section 2: Consistency in the use of macroprudential tools and streamlined oversight

The calibration and application of macroprudential tools differ across Member States. Most respondents suggested that the use of buffers (i.e., O-SII buffer, systemic risk buffer, countercyclical buffer) and other macroprudential measures (e.g., risk weight measures under Art 458 CRR) by national authorities can be inconsistent and creates an uneven playing field across the EU and reduces the effectiveness of macroprudential measures by national authorities. The heterogeneity in O-SII buffer rates across banks and across Member States is not fully justified by fundamentals according to several respondents. A more coherent EU-wide approach to O-SII identification and buffer rate calibration is widely seen as necessary. Several respondents claimed that administrative burdens linked to activation, reciprocation, authorisation and extension procedures for the use of macroprudential tools can contribute to an inaction bias and result in systemic risks not being addressed appropriately, or at all, by national authorities.

Many respondents argued that the existing toolkit is too complex and that some of the instruments should be either significantly streamlined or even removed to make the framework more effective. About two-thirds of respondents confirmed that there are instruments in the current framework that are redundant or need to be redesigned to make them fit for purpose.

Proposals emerged from the responses to the consultation to address inconsistency and reduce complexity in the macroprudential framework, including:

- Further clarity on the calibration and application of buffers: most responses called for further clarity on the distinction between instruments to promote a more consistent use of tools by national authorities and to reduce overlaps.
- In particular, an EU-wide methodology on identifying O-SIIs and calibrating their buffer rates to foster consistency, market integration and reduce undue heterogeneity could be developed.
- The use of a common denominator for sectoral and general SyRB rates before applying the additivity rules and activation thresholds was suggested by several respondents.
- Reducing administration burdens: there was general support for streamlining notification, authorisation, extension, and reciprocation procedures, and several suggestions were made to increase the use of mandatory instead of voluntary reciprocity.
- EU-monitoring of macroprudential stance: some respondents called for strengthened EU-level Mmonitoring and oversight of the overall macroprudential stance of

Member States within the current allocation of responsibilities between national and EU authorities.

- Streamlining or removal of current provisions: several suggestions were presented, such as creating a single risk weight instrument for addressing residential real estate risk from a macroprudential perspective that allows authorities to set floors or tighten risk weights for exposures secured by real estate on macroprudential grounds. Bank respondents advocated a removal of the SyRB. Some respondents called for removing Articles 138 and 139 CRD (thirdcountry countercyclical buffers) as they consider the SyRB better suited to address risks emanating from third countries.

Section 3: Missing tools and new risks

Only about one-fifth of respondents believe that the EU macroprudential toolkit is comprehensive and presents no major gaps. There is broad support for the introduction of borrower-based measures (BBMs) in the macroprudential toolkit, but with a high degree of flexibility for Member States, who should remain fully responsible for the use of these instruments. There appears to be a strong consensus also that BBMs should therefore remain outside the scope of the ECB's top-up powers for macroprudential measures. Some respondents also argued that the scope of borrower-based measures should be extended to non-bank lenders. Only a few questioned the need for harmonized minimum standards on BBMs, indicating that the presence of these in EU law will not ensure that rules are applied homogenously, and/or that differences across national mortgage markets would not justify common standards.

Some respondents consider that the unique features of climate change may have a systemic dimension (e.g., feedback loops, second round effects, complexity, long time horizons) but 23 respondents believe it is too early to introduce new, dedicated macroprudential tools. Many suggest to first explore the use of existing tools in the CRR/CRD, notably the sectoral systemic risk buffer and large exposure limits, before introducing new macroprudential measures. Yet, some respondents suggest considering new tools, such as concentration limits or charges, or continuing the work on these tools with a high priority, also if proposals are considered after this review.

For wider Environmental, Social, and Governance (ESG) risks and cyber-security, most respondents did not seem convinced that new, dedicated macroprudential instruments are needed to address systemic risks emerging from these areas, or think that more analysis and data are required, taking into account what can already be achieved with the existing or forthcoming micro- and macroprudential instruments.

Given the systemic aspects of cyber risks, some respondents point to considering, now or at a later stage, systemic cyber resilience scenario stress testing and further requirements, for instance to avoid operational concentration at one point of failure.

17 respondents supported "activity-based" regulation to ensure that non-banks (particularly Bigtech or Fintechs) are covered by the same macroprudential requirements if they pose similar systemic risks. According to these respondents, there is a need to address systemic risks in the non-bank area in the respective entity-based regulatory frameworks or via activity-based regulation, taking into account growing relevance and market shares. However, no specific reform proposals emerged for exposures of banks to non-banks.

Next steps

This targeted consultation complements a Call for Advice to the European Banking Authority, European Systemic Risk Board and the European Central Bank which closed on 31 March 2022. The Commission services will prepare an evaluation of the functioning of the macroprudential framework, as well as an impact assessment of various policy options that emerge from the consultation and the call for advice. A decision on whether to submit legislative proposals to the European Parliament and the Council will be taken on the basis of this impact assessment.

1 Recital (27) of Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board ('ESRB Regulation').

VI. European Commission

Review of the EU macroprudential framework. Call for advice

CONTEXT AND SCOPE OF THE REVIEW

Article 513 of Regulation (EU) No 575/2013 requires the Commission to complete a review of the macroprudential provisions in the CRR and Directive 2013/36/EU (CRD)[1] by June 2022 and, if appropriate, to submit a legislative proposal to the European Parliament and to the Council by December 2022.

The mandate in Article 513 CRR offers the opportunity to review and improve the EU macroprudential framework applicable to banks. Article 513 CRR envisages a broad scope for the review, requiring the Commission to assess the effectiveness, efficiency and transparency of the macroprudential framework, listing a number of specific issues to be considered in view of a possible legislative proposal. Additional issues related to the design and use of the instruments and to the governance of macroprudential policy have become apparent over recent years and in particular during the Covid-19 pandemic – the first test of the macropruential framework in a major economic crisis.

The advice should cover four broad areas:

- overall design and functioning of the buffer framework;
- missing or obsolete instruments;
- internal market considerations; and
- global risks.

These issues shall be analysed taking into account ongoing discussions at the international level and the Covid-19 crisis experience. The overall aim of the review is to improve the framework's functioning in the medium term, focusing on its effectiveness, efficiency and transparency and taking into account the impacts on other frameworks (prudential, resolution). Any suggested changes should be justified as far as possible on the basis of quantitative evidence and/or economic theory. This applies particularly to measures that would imply higher overall capital requirements. Departures from the international minimum standards set by the Basel Committee should be avoided, but the addressees could signal and justify any changes to these standards that they would regard desirable for the EU.

When proposing amendments to the framework, it is important that relevant costs and benefits of different options, including the baseline option of no change, are assessed and quantified (cost-benefit analysis or CBA hereafter).

The Commission is aware that, CBAs for some of the issues raised in this call for advice, may not be entirely feasible within the given timeframe and with the resources available. The advice should be delivered on a best-effort basis, using the latest knowledge and reflecting work that is already available.

[omissis]

2. MISSING OR OBSOLETE INSTRUMENTS

While the EU has a broad range of capital buffers, other tools may still need to be added to the EU legal framework, while some existing ones may be or may become obsolete.

Many Member States are using borrower-based measures (BBMs) in addition to capital-based and other measures to prevent credit-fuelled overheating in the residential real estate sector. In principle, borrower-based measures could also target non-financial corporates (NFCs), but very few Member States have developed such tools for NFCs, typically focusing on commercial real estate.

Macroprudential policy has so far been mainly of a preventive and longer-term nature. The Covid-19 shock has tested the framework's suitability for crisis management. Article 459 CRR empowers the Commission to take short-term measures in response to changes in the intensity of micro- or macroprudential risks (under very restrictive conditions), but it is difficult to imagine a scenario where the conditions for using this article would be met, and where the tools provided for in the article would be appropriate. There was a consensus in the current crisis on the need to impose restrictions on the distribution of capital to investors and staff even before the CBR is breached, but there are no clearly defined powers for national or EU authorities to apply such restrictions on a system-wide basis. The Commission was therefore given a mandate to assess whether competent authorities should be empowered by EU law to impose restrictions on such distributions in exceptional circumstances (Article 518b CRR).

The review should also seek to identify instruments that may be obsolete. Having multiple prudential tools that can target similar risks would create unwarranted complexity and may contribute to a more fragmented internal market. In particular, forthcoming legal changes due to the finalisation of Basel III reforms may have implications for macroprudential instruments that directly or indirectly affect risk-weights such as those provided under Articles 164 and 458 CRR.

The Commission seeks advice on the following questions:

Based on the evaluation of the current framework, are there any tools that are missing in the current macroprudential framework or that have or may soon become obsolete, and if so, which ones? In particular:

- Should certain instruments be added to the EU macroprudential toolkit? Specifically, how could the EU macroprudential framework support and ensure a more comparable and effective use of borrower-based measures across MS to target potentially unsustainable borrowing by households and non-financial corporates?
- Is there a need to enhance the crisis management capacity of macroprudential policy, at the Union and/or national level, in particular to impose system-wide restrictions on distributions in exceptional circumstances?
- Have certain instruments become obsolete or could they become obsolete over the coming years? In particular, to what extent should provisions be maintained that allow the adjustment of risk weights or risk weight determinants for real estate exposures on macroprudential grounds once Basel III input and output floors apply?

Supporting analysis should focus primarily on the following issues:

Review evidence on the use and effectiveness of borrower-based measures and assess, based on a CBA, how their optimal use could be supported via the macroprudential framework in EU law, for instance by (i) introducing harmonised definitions and indicators in the area of BBMs; (ii) enhancing the availability of data (for instance from credit registers) needed for the effective application of BBMs; and (iii) introducing a minimum, harmonised BBM toolkit for residential real estate, commercial real estate, and/or for non-financial corporations. Assess the costs and benefits of different options not only from a financial stability perspective, but also with regard to the functioning of the internal market (market fragmentation, reciprocation) and possibly social impacts (access to home ownership) and administrative burdens.

Assess, based on a CBA and taking into account the effectiveness of authorities' use of existing tools to reduce distributions during the Covid-19 crisis, whether and how additional powers to restrict system-wide distributions should be introduced for macroprudential authorities and specified in EU law. Review evidence on the impact of system-wide distribution restrictions on banks' overall resilience, on the integrity of intragroup transferability of resources within cross-border groups, and on banks' access to market funding and ability to raise additional capital. If it is concluded that system-wide distribution restrictions are needed, propose criteria that could govern the activation of system-wide distribution restrictions at the EU group level (or at the individual level where the financial institution is not part of an EU group), including possibly at sub-consolidated or individual level, and the potential interactions of such discretionary restrictions with automatic distribution restrictions pursuant to Articles 141 and 141b CRD, as well as other relevant microprudential measures. Present any other crisis management tools (new tools or coordination of existing ones) that should be considered in the macroprudential sphere, together with the costs and benefits thereof.

Assess, based on a CBA, whether certain macroprudential instruments may become obsolete or should be reviewed (notably Article 164 and certain provisions of Article 458 CRR) and explore options for possible adaptations thereof, taking into account the experience so far with macroprudential policies and recent and upcoming changes in the broader context (notably the introduction of sectoral systemic risk buffers and the forthcoming Basel III finalisation with the introduction of input and output floors).

[omissis]

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

VII. European Banking Authority

Advice on the review of the macroprudential framework. Response to the Commission's july 2021 call for advice

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Executive summary

The European Banking Authority (EBA) welcomes the opportunity to provide input to the 2022 review of the EU macroprudential framework, in response to the European Commission's call for advice (CfA).[1] The CfA seeks input on four aspects: (1) overall design and functioning of the buffer framework, (2) missing or obsolete instruments, (3) internal market considerations and (4) global risks.

The EBA reply to the CfA reflects the scope of EBA mandates and tasks and therefore does not address all questions included in the Commission's call for advice.

Overall design and functioning of the buffer framework

Significant fiscal, monetary and prudential support measures – including the release of regulatory capital buffers – were introduced during the COVID-19 pandemic. This allowed banks to continue lending. Limits on dividend payments also helped strengthen bank capital positions. The combined effect of these measures meant that the pandemic did not result in a comprehensive test of the current macroprudential framework. Looking ahead, it will be important to rebuild regulatory capital buffers to ensure they can be released if needed.

Several lessons have however been learned since the inception of the macroprudential framework that can be used when considering changes to the framework. One lesson is that it may be desirable to simplify the procedures for existing macroprudential tools. Another is that it might be helpful to increase harmonisation for other tools. Both should lead to a better functioning of the Single Market. In addition, efforts to improve the framework should also consider developments at the international level.

An important requirement when considering changes to the macroprudential framework is that a clear distinction should be maintained between microprudential and macroprudential tools. This includes having clear roles and responsibilities of the different authorities involved. This is needed to ensure that the complex regulatory framework in the EU, including macroprudential measures, works effectively.

While it is acknowledged that parallel requirements restrict banks' ability to use capital buffers, further evidence on how institutions will adjust their capital and liability positions in response to the development of the regulatory framework (e.g. the implementation of Basel III and minimum requirement for own funds and eligible liabilities (MREL), the development of the Supervisory Review and Evaluation Process (SREP) under CRD5) will need to be gathered.

The implementation of the CRR2, CRD5 and BRRD2 frameworks is very recent and has introduced several new elements. Hence, with respect to the interaction of macroprudential measures and other capital requirements such as leverage ratio (LR), own funds and eligible liabilities (MREL) requirements, the European Banking Authority (EBA) considers that a more comprehensive evaluation should be performed before considering more substantial changes to the current framework.

Missing or obsolete instruments

In response to the COVID-19 pandemic, competent authorities across Europe recommended dividend pay-out restrictions in a concerted action, and without the need to enact restrictions in hard law. Data on dividend payments throughout 2020 confirm that credit institutions complied with these recommendations, which resulted in an increase of capital reserves in 2020.

Given that these measures proved to be an effective complement to macroprudential measures taken during the crisis, the EBA does not advocate applying additional tools and powers to enact system-wide restrictions.

Input and output floors were recently introduced in the Basel III standard to reduce excessive variability of risk-weighted assets generated by internal rating-based (IRB) models. Introducing these floors might lead to a potential recalibration and adjustment of risk weights for some macroprudential measures, particularly for real-estate exposures. However, it is too early to draw conclusions on the interaction between the input and output floors and the macroprudential measures. This assessment should be postponed to the next review of the macroprudential toolkit once the input and output floors are fully applicable.

Although not covered directly in the reply to the CfA, the EBA notes that borrower-based measures (BBMs) may help ensure sound lending standards and thereby mitigate financial stability risks.

Internal market considerations

The macroprudential framework relies on national authorities to adopt the measure best suited to address a specific local risk and to promote financial stability for the local banking sector. This flexibility for national authorities, if not used consistently across jurisdictions, may jeopardise the objective of creating a level playing field in the European financial market and may allow for regulatory arbitrage. Based on experience gained with the application of macroprudential measures over the past decade, the EBA recommends harmonising and simplifying certain aspects of the framework.

- The identification of O-SII is currently framed by the EBA Guidelines, whereas the setting of the level of the O-SII buffer is currently largely left at the discretion of national authorities, leading to a high variation of O-SII buffer rates that cannot be fully explained by differences in underlying systemic risk. This heterogeneity calls for a mandate to be given to the EBA to develop, in cooperation with the ESRB, common methodologies covering both the identification of O-SIIs and the setting of buffer rates, which should ensure further harmonisation, while allowing specific features of national banking systems to be considered.
- The EBA sees room for enhancing and simplifying the procedures of the macroprudential measures in the Capital Requirements Regulation (CRR) framework and proposes targeted changes to Article 124, Article 164 and Article 458 of the CRR. Clear delineation of responsibilities and close cooperation between all authorities in charge of microprudential and macroprudential policy is essential to ensure an efficient application of these measures.
- The sectoral systemic risk buffer is a recent addition to the macroprudential toolkit, which allows national authorities to establish a buffer for a subset of exposures. The EBA proposes a couple of clarifications to be made in the Capital Requirements Directive (CRD), which were identified by national authorities during the implementation into national legislation and which aim to provide more clarity on the scope and governance procedures.

Global risks

Given that regulatory initiatives are currently being worked on as regards several global risks, including environmental risks, cyber security and crypto assets, the EBA considers it premature to introduce new macroeconomic tools to address the systemic aspects of these risks at this stage.

- Efforts are currently underway to identify ways to address environmental risks in the microprudential framework. While environmental risk may have financial stability repercussions, further development of this work is necessary before concluding on definitive advice on how to address environmental risks from a systemic point of view.
- Crypto assets remain a small portion of the overall financial system, and interconnectedness identified between crypto assets and the traditional financial sector remains limited. The finalisation of the Regulation on Markets in Crypto-assets (MiCA), and experience acquired in its application, will be informative in subsequent assessments of the need for any macroprudential tools in relation to crypto asset markets.
- Cyber security risk requires continued focus on operational resilience and is at the heart of the upcoming Digital Operational Resilience Act (DORA) and the Directive on measures for a high common level of cybersecurity across the EU (NIS2). The potential need for additional macroprudential instruments to address the systemic risk component associated with cyber risk should be further assessed considering the impact of the implementation of those two legal acts.

The increasing trend of non-bank lending, including FinTech lenders and peer-to-peer lending platforms over the past years, requires the establishment of an oversight and monitoring system for non-bank lenders. It also calls for the scope of the macroprudential framework to be enlarged, enabling the application of activity-based macroprudential measures for non-bank lenders.

[omissis]

5.3 New global providers of financial services

As part of the European Commission's Call for Advice on Digital Finance,[24] the EBA is currently carrying out an analysis of non-bank lending in the EU, focusing on entities that are not subject to any sectoral EU directives or regulations and covering entities such as leasing companies, factoring companies, FinTech lenders/peer-to-peer lending platforms and BigTech lenders.

In general, the interim findings of the analysis show that non-bank lending activities vary across Member States and, in some MS, are subject to national regimes regulating such activities. In those Member States, national authorities appear to have a good understanding of the activities of non-bank lenders that are regulated at a national level and subject to mandatory authorisation/ registration. By contrast, authorities often do not have information on activities of non-bank lenders that remain unregulated at a national level, if they are allowed to operate in their jurisdictions. It is therefore important that enough data and information is collected to allow authorities to monitor the build-up of systemic risks in a timely manner.

While there are challenges in data availability to precisely lay out the overall extent of non-bank lending in the EU, the information provided by national authorities and other sources indicates that non-bank lending remains very small in volume compared to credit provided by banks.

However, according to the survey on non-bank lending, a number of competent authorities have indicated that – in light of the recent increase in non-bank lending provided by new FinTech entities – consideration must be given to some potential risks, in particular:

- Over-indebtedness risk and creditworthiness: while this is not currently identified as a high risk for non-bank lenders, relatively lower credit underwriting standards and unsecured loans granted to vulnerable borrowers may increase their over-indebtedness and financial fragility. Moreover, since not all non-bank lenders are required to report data to the credit registers, the informative value of these databases may become less valuable as an instrument to assess creditworthiness.

- Contagion and step-in risk:[25] this risk may become relevant when non-bank lenders, as part of a financial group, become exposed to credit institutions and financial institutions.[26] However, according to the ESRB 2021 EU Non-bank Financial Intermediation Risk Monitor, the interconnectedness of financial corporations engaged in lending (FCL), which broadly overlap with the entities reflected in the EBA analysis of non-bank lending with the banking system appears to be low, as only 4% of FCL assets in 2020 had direct counterparty exposure to the banking sector.[27]

- Regulatory arbitrage: while some Member States apply the same macroprudential tools for non-bank lenders as for banks (e.g. loan-to-value (LTV) or loan-to-income (LTI) limits, debt-service-to-income (DSTI) ratios, maturity limits), regulatory arbitrage risks may arise if borrower-based measures (BBMs) are only applied to banks and not extended to non-bank lenders. It has been observed that in such situations banks may have the incentive to circumvent the restrictions by buying up loans to households issued by non-bank lenders. Finally, most macroprudential measures applied to banks are capital-based (e.g. buffers), while only in a few jurisdictions non-bank lenders are requested to own capital (and thus be possibly subject to capital-based measures), thus further increasing the risk of regulatory arbitrage.

In view of the above, a first step to address potential concerns may be the establishment of an oversight and monitoring system at national and/or EU level for non-bank lenders, which would help assess the build-up of systemic risks on a timely basis, as well as identify and address the most compelling risks at a macro level. As a second step, a minimum set of EU-wide activity-based rules for lending may be developed based on a minimum harmonisation of the main elements of already widely applied activity-based instruments, such as macroprudential BBMs for new residential real estate (RRE) financing, in order to facilitate their reciprocity among Member States. Finally, all credit providers (i.e. not only credit institutions but also non-bank lenders) may be covered by a macroprudential framework, allowing for the possibility to introduce activity-based macroprudential measures, which should consider also the application of any requirement at entity level. In turn, this may also reduce the scope of regulatory arbitrage.

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[1] https://www.eba.europa.eu/sites/default/documents/files/document_library/About%20Us/Missions%20and%20tasks/Call%20for%20Advice/2021/CfA%20on%20review%20macroprudential/1019954/20210630%20CfA%20macropru%20review.pdf

[24] The Joint ESAs response to this Call for Advice can be found here: https://www.eba.europa.eu/esas-recommend-actions-ensure-eu%E2%80%99s-regulatory-and-supervisory-framework-remains-fit-purpose-digital.

[25] Step-in risk is defined as the risk that a bank 'provides financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support' (see BCBS, Guidelines on Identification and management of step-in risk – October 2017).

[26] To this extent, note that according to SSM Supervisory Board Chair, Andrea Enria (2019), new risks may emerge from the recent trend of 'slice and dice' the banking value chain, so that each small portion of the value chain may be occupied by one individual player, thus creating a new level of interconnectedness. If this trend gains more traction, then this will increase the risk that 'a problem in one part of the value chain could travel in all directions, affecting many players' thus increasing systemic risk.

[27] ESRB EU Non-bank Financial Intermediation Risk Monitor 2021 (August 2021).

VIII. European Central Bank

Response to the European Commission's call for advice on the review of the EU macroprudential framework. March 2022

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   3.1 Should certain instruments be added to the EU macroprudential toolkit? Specifically, how could the EU macroprudential framework support and ensure a more comparable and effective use of borrower-based measures across MS to target potentially unsustainable borrowing by households and non-financial corporates?

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4.3 Are the provisions on reciprocation adequate to maintain a level playing field and to prevent the circumvention of national macroprudential measures through regulatory arbitrage? Is there scope for simplification or streamlining of the reciprocation framework and procedures? If so, which options do you see and how would you evaluate them?

4.4 Are the hard- and soft-law instruments (such as the ECB's power to top up buffers, the Commission empowerment in Article 459, ESRB warnings and recommendations) adequate to ensure that national authorities take sufficient and appropriate action to address systemic risks? If not, which additional measures would you see and how would you evaluate them?

5. Global risks

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5.2 Given the increasing importance of market-based finance and trading, is there a need to enhance the tools for monitoring and mitigating banks' risk exposures, while at the same time strengthening the resilience of banks' market making functions and the provision of market liquidity in crisis situation?

5.3 Are macroprudential tools appropriate and sufficient to prevent and mitigate financial stability risks arising from the changing nature of systemic risks (including due to climate change, new global providers of financial services, cybersecurity and crypto assets)?

1. Executive summary

The European Central Bank (ECB) welcomes the opportunity to provide input to the European Commission's Call for Advice (CfA) on the review of the EU macroprudential framework. The COVID-19 pandemic highlighted the fact that a comprehensive set of policies is necessary to address large and disruptive shocks to the financial system. The EU banking system proved resilient and continued to support the real economy during the crisis. This was due to: (a) the increased levels of resilience achieved thanks to the regulatory reforms put in place after the Global Financial Crisis; (b) implementation of micro- and macroprudential policies; (c) the extraordinary fiscal, monetary and prudential support measures put in place. Macroprudential policy is a crucial component of this mix, as it helped stabilise the provision of key services by giving capital relief to the banking sector. The pandemic also brought to the fore areas for improvement in the design and functioning of the macroprudential framework. The ECB's advice aims to support the legislative process to address the shortcomings identified in the review of the EU macroprudential framework. Finally, the ECB supports full, timely and consistent implementation of the final Basel III standards agreed by the Basel Committee on Banking Supervision in EU legislation. These reforms will further enhance the resilience and stability of the financial system.

The review of the EU macroprudential framework was preceded by the ECB's monetary policy strategy review, which emphasised that financial stability is a precondition for price stability and vice versa. This recognised that in view of the price stability risks generated by financial crises, there is a clear conceptual case for the ECB taking financial stability considerations into account in its monetary policy deliberations. The review also stressed that monetary policy is not primarily responsible for guaranteeing financial stability; macroprudential policies (together with microprudential policies and financial regulation) remain the first line of defence against financial stability risks. Monetary policy and macroprudential policy pursue their respective statutory objectives of price stability and financial system stability and in doing so are in most cases complementary. Monetary policy may affect financial stability risks: in one direction, accommodative monetary policy can reduce credit risk by boosting activity levels; in the other direction, accommodative monetary policy may encourage the build-up of leverage or affect asset prices. In a similar vein, macroprudential policies have implications for price stability; for instance, measures that avoid a build-up of imbalances reduce the likelihood of future financial crises with negative effects on price stability. The interplay between monetary and macroprudential policies strengthens further the case for enhancing the effectiveness of the macroprudential framework in the EU.

The ECB response covers the four broad areas included in the CfA: the overall design and functioning of the buffer framework, missing and obsolete instruments, internal market considerations and global risks. The CfA reflects the Commission's mandate to complete a review of the macroprudential provisions in the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD) by June 2022 and, if appropriate, to submit a legislative proposal to the European Parliament and the Council by December 2022. As a result, the proposals and considerations included in this response focus on the provisions contained in the CRR and the CRD. The response also offers some reflections on global risks, inspired by the relevant section of the CfA, but does not contain any concrete proposals on other EU legal acts, e.g. relating to non-banks; nor does it discuss institutional and governance arrangements not covered by the CRR and CRD. However, given the interactions between the resolution and macroprudential frameworks (e.g. on information exchange), the reviews of both frameworks should be aligned. Finally, the response includes an annex that provides analytical and, where possible, empirical analyses underpinning the proposals (Annex 1). It is accompanied by a background document on specific policy options to enhance macroprudential space in the banking union and the European Union (Annex 2).

Regarding the revision of the capital buffer framework, the ECB has three sets of proposals (see Section 2):

First, the ECB supports creating additional macroprudential policy space – in the form of a higher amount of releasable capital buffers – to enhance the ability of the financial system to withstand large, systemic shocks by better enabling banks to absorb losses while maintaining the provision of key financial services to the real economy. The ECB highlights the importance of increasing the availability of releasable capital buffers to enhance macroprudential authorities' ability to address large and disruptive systemic shocks that may go beyond the unwinding of domestic imbalances and may hit (large parts of) the banking union simultaneously. The ECB has identified a number of policy options that could be pursued: (a) a fully or partially releasable capital conservation buffer (CCoB); (b) a positive neutral rate for, or more active use of, the countercyclical capital buffer (CCyB); (c) a core rate for the releasable systemic risk buffer (SyRB), or a possible mix of these policy options (see also Annex 2). The ECB response thoroughly discusses the advantages and disadvantages of the three policy options, aiming to reflect a balanced overview of the opinions of the authorities in the banking union, but does not establish a hierarchy of options or recommend one specific option in view of the EU macroprudential review. Moreover, some authorities consider the present framework flexible enough to create higher releasable capital buffers. Beyond the option to increase the amount of releasable capital buffers, the ECB favours increasing the usability of buffers which are not releasable. The ECB supports strengthening the features of Additional Tier 1 (AT1) instruments to reduce the stigma effects associated with banks cancelling AT1 coupon payments when they fall beneath the level of their combined buffer requirements. The challenges associated with market perceptions of the features of AT1 instruments point to a more fundamental concern over the complexity of the capital framework; the ECB supports further work at the international level to consider ways of reducing the overall complexity of the prudential regime.

Second, the ECB suggests increasing the flexibility and effectiveness of the CCyB framework by supporting timelier activation in the build-up phase and release in stress periods. The ECB supports strengthening the role of other quantitative cyclical indicators that could be considered when setting a CCyB rate, reducing the prominent role of the credit-to-GDP gap.[1] The ECB also suggests clarifying the CRD provisions on the implementation of the CCyB (e.g. allowing multiple decisions within a quarter, or applying a shorter transitional period if justified by the circumstances), which would increase the flexibility of the framework.

Third, the ECB suggests enhancing information exchange between resolution, competent and designated authorities. This would allow them to exercise their respective mandates in an effective and timely manner, including for macroprudential policy and financial stability analysis. Looking ahead, the ECB sees merit in further assessing the interactions between the prudential and resolution frameworks, given their implications for the functioning of the buffer framework. The ECB suggests that in the subsequent review of the EU's macroprudential policy framework the Commission, after consulting the ESRB, should assess whether the leverage ratio and the minimum requirement for own funds and eligible liabilities (MREL) present material obstacles to buffer usability, due to multiple use of capital for buffers and minimum requirements.

Fourth, the ECB does not support extending leverage buffers to O-SIIs at this stage. O-SII leverage buffers would strengthen the resilience of a small number of these institutions at the current juncture. However, introducing them might decrease the usability of releasable buffers in the risk-based framework and increase potential procyclical adjustments.[2] In the subsequent review of the EU's macroprudential rules the Commission, after consulting the ESRB and the EBA, should assess whether additional leverage buffers need to be introduced.

Regarding missing and obsolete instruments, the ECB has three main proposals (see Section 3):

First, the ECB supports introducing a data collection requirement for a minimum set of common lending standard indicators for residential real estate (RRE) loans for monitoring purposes. These lending standards indicators should be based on the common definitions in ESRB Recommendation 2016/14.[3] The objective is to enhance the comparability of both risk assessments and, indirectly and gradually, prudential policy stances on borrower-based measures (BBMs) in the RRE sector across jurisdictions, supporting financial stability surveillance in the EU. It is important that the activation, design and calibration of macroprudential limits to lending standard indicators, i.e. BBMs, should remain within the remit of national authorities, to effectively address the risks identified and account for national specificities given the heterogeneity across national mortgage and real estate markets. The data collection requirements would not constrain national authorities from using national definitions aligned with domestic specificities or collecting an even broader set of lending standard indicators to inform policy, including the application of BBMs at the national level.

Second, the ECB proposes consolidating all macroprudential risk weight measures for real estate into a single article. This would streamline the various legal provisions on regulatory risk weight adjustments for real estate and disentangle macroprudential and microprudential provisions.

Moreover, consolidating the different provisions allowing risks weights to be tightened to address real estate risks would establish a consistent administrative procedure that would facilitate macroprudential policy action while ensuring the integrity of the Single Market for measures with a more material impact.

Third, the ECB does not at this stage support the introduction of the power to impose binding system-wide restrictions on distributions at Union and/or national level in the CRR/CRD. Limiting distributions is a way for banks to retain their capacity to absorb losses and ability to continue providing credit in times of crisis. The relevant recommendations by EU institutions, including the ECB, and the corresponding national actions, proved effective during the COVID-19 crisis. These measures were of an exceptional and temporary nature, reflecting the extraordinary uncertainty that the banking sector faced at the outset of the pandemic. Introducing the power for authorities to impose system-wide restrictions on distributions might signal that these measures could occur more frequently in future, which could have a negative impact on banks' valuations and limit their ability to raise capital. Such effects could be particularly pronounced if the EU were to take this step unilaterally, without other major jurisdictions introducing similar powers for their authorities.

Regarding internal market considerations, coordination mechanisms and procedures, the ECB has the following main proposals (see Section 4):

First, the ECB suggests mandating the EBA, in consultation with ESRB, to issue guidelines on a revised methodology for O-SII identification and buffer calibration. The proposal aims to further reduce the risk of unjustified heterogeneity in the setting of O-SII buffers and to develop a common methodology that would lead to a more consistent treatment across the EU. The EU-wide guidance would need to be flexible to ensure that national specificities, new developments and insights can be reflected appropriately.

Second, the ECB suggests mandating the ESRB to report on identifying systemic risks for the purposes of setting the SyRB and, if appropriate, to issue a recommendation to designated authorities on the application of the SyRB on the basis of this report. Differences in the current approaches to implementing the SyRB in the EU are justified to some extent by its use to address country-specific systemic risks, but they indicate there is a possibility of systemic risks being treated unevenly across countries. An ESRB report would support improving the consistency of treatment in addressing systemic risks within the EU, without constraining use of the SyRB as a flexible tool to cover both risks not mitigated by other tools and any new systemic risks that may emerge in future. On the basis of this report, the ESRB could issue a recommendation to designated authorities, if considered appropriate.

Third, the ECB suggests streamlining the procedures governing national flexibility measures set out in Article 458 CRR. Targeted amendments could streamline the authorisation and extension procedures for Article 458 measures by (a)indicating that they can be implemented in cases when systemic risks remainelevated, and not only when an increase in the intensity of the systemic risk has been identified; (b) clarifying the scope of the assessments performed by the ESRB and EBA under their institutional mandates; (c) enabling the ESRB to take existing assessments of systemic risks for participating Member States into consideration; (d) replacing the current recurring mandatory comprehensive assessment by the ESRB, the EBA and the Commission with a simplified non-objection approach to extending an existing measure under Article 458.

Fourth, the ECB suggests revising the rules on calculating the thresholds for the sectoral SyRB and the interaction between the systemic risk buffer (SyRB) and the capital buffers for global and other systemically important institutions (G/O-SIIs). The ECB suggests converting the sectoral and general SyRB rates to a common denominator, the total risk exposure amount (TREA), before applying the additivity rules and thresholds triggering EU governance procedures. This proposal aims at establishing a consistent approach, with a view to eliminating adverse incentives that could discourage implementation of the sectoral SyRB. Moreover, it ensures that EU governance procedures will relate to the impact of these measures on the Single Market, while avoiding placing an undue burden on EU authorities for measures with a limited capital impact.

Regarding global risks, the ECB sees the rationale for removing the CRD provisions on third-country CCyB rates, given the significant challenges to activating this instrument and the high coordination costs related to its exposure-based nature. The SyRB can be used to address third-country risks in a broader context than that of the third-country CCyB, without this constituting a unilateral decision by an EU authority to increase the rate of a macroprudential instrument that is part of the third country toolkit. With regard to market-based finance, the ECB does not at this stage see any need for a regulatory change in the macroprudential toolkit for banks to address the risk of exposures to non-banks. However, the ECB supports strengthening the regulatory framework for non-banks, including from a macroprudential perspective. This should include limiting liquidity risk in both money market and open-ended funds as well as the procyclicality of derivative margins. Mandatory holdings of public debt and increased weekly liquid asset requirements for private debt funds would enhance their shock-absorbing capacity. In addition, liquidity buffers for money market funds should be made more practical and authorities should have a role in directing their use. Finally, the ECB stresses the unique features of climate-related and broader environmental risks and is actively participating in the debate on designing policy measures to capture them. Any evidence-based assessment may well extend beyond the completion of the EU macroprudential framework review; however, the Commission could consider inserting any related proposals into EU law separately but in a timely manner, after consulting the ESRB and ECB. Finally, with regard to cyber risk, given the relatively early stage of analysis, the ECB may consider macroprudential policy proposals at a later stage.

[omissis]

3. Missing or obsolete instruments

3.1 Should certain instruments be added to the EU macroprudential toolkit? Specifically, how could the EU macroprudential framework support and ensure a more comparable and effective use of borrower-based measures across MS to target potentially unsustainable borrowing by households and non-financial corporates?

11. The ECB suggests introducing to the CRR a data collection requirementfor a minimum set of lending standard indicators for residential real estateloans for monitoring purposes.

Introducing a requirement to collect data for a minimum set of lending standard indicators for residential real estate (RRE) loans as defined in Recommendation ESRB/2016/14[27] for monitoring purposes would enhance the comparability of risk assessments in the RRE sector and the prudential policy stance on borrower-based measures (BBMs) across EU jurisdictions. The assessment of RRE-related risks and the design and implementation of policies to address them crucially depend on the availability of reliable, granular and timely data on real estate markets. Indicators of lending standards such as loan/value (LTV), debt service/income (DSTI) and debt/income (DTI) ratios are key to evaluating the sustainability of borrowers' debt and assessing the riskiness of banks' mortgage loan portfolios, as they relate to borrowers' probability of default and the loss given default. Regular reporting of these lending standard indicators, based on common EU definitions,[28] for monitoring purposes would enhance the comparability of RRE risks and, indirectly and gradually, the BBM policy stance across EU countries, supporting financial stability surveillance in the EU. Granular information on lending standards is also crucial for hybrid regulatory instruments such as risk weights differentiated by the level of lending standard (e.g. higher risk weights for loans carrying high LTV ratios).

The introduction of the data collection requirement for a minimum set of lending standard indicators for RRE loans does not imply any change in the design or institutional attribution of BBMs and will be based on the existing work of the ESRB, with a view to minimising compliance and implementation costs. Activating, designing and calibrating macroprudential limits on lending standard indicators, i.e. BBMs, should remain within the remit of national authorities, so as to effectively address the risks identified and allow for national specificities given the heterogeneity across national mortgage and real estate markets. Recommendation ESRB/2016/14 can provide a basis for establishing common definitions and the corresponding data collection requirements.[29] More specifically, the collection of indicators based on common definitions should use existing reporting frameworks at the national level, where available, and allow for an appropriate transition period. It should not constrain national authorities from using national definitions aligned with domestic features for policy purposes, nor from collecting a broader set of lending standard indicators to inform the application of BBMs at the national level.

[omissis]

1 These indicators could be complemented by qualitative information, ESRB guidance and expert judgement.

2 This reflects the fact that, given their structural nature, an O-SII leverage buffer would not be releasable and assumes that banks' reluctance to dip into their risk-weighted capital buffers extends to leverage buffers too. The above results should be reassessed once MREL is fully phased in, as it may have implications on the magnitude of the impact.

3 Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (ESRB/2016/14) (OJ C 31, 31.1.2017, p. 1).

27 Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (OJ C 31, 31.1.2017, p.1), as complemented and amended by Recommendation ESRB/2019/3 (OJ C 271, 13.8.2019, p. 1).

28 While based on the ESRB Recommendation, the common definitions of indicators would also have to consider a number of related concepts already defined in the CRR as well as the possible need to provide some flexibility in view of national specificities.

29 While based on the ESRB Recommendation, the common definitions of indicators would also have to consider a number of related concepts already defined in the CRR as well as the possible need to provide some flexibility in view of national specificities.

IX. European Systemic Risk Board

Review of the EU macroprudential framework for the banking sector. March 2022. Response to the call for advice

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Imprint and acknowledgements

Executive summary

The European Systemic Risk Board (ESRB) welcomes the opportunity to contribute to the European Commission's call for advice (CfA) on the 2022 Review of the EU Macroprudential Framework. The European Union (EU) banking system has improved its resilience thanks to the significant reforms introduced after the global financial crisis. This enhanced resilience – along with the substantial fiscal, monetary and prudential support that was swiftly activated – has allowed the banking system to continue lending to the real economy during the pandemic crisis. Overall, the macroprudential framework has functioned well over the last decade and during the pandemic crisis, making a significant contribution towards maintaining the provision of bank services by providing capital and liquidity relief. At the same time, the effectiveness of the macroprudential framework could be enhanced to allow macroprudential authorities to take a more proactive and forward-looking approach given the risks that have recently emerged and are suddenly materialising. With its response, the ESRB aims to emphasise the key priorities for making the improvements necessary to strengthen the macroprudential framework for the next decade.

The ESRB response covers the four broad themes on which the Commission is seeking advice, namely (i) the overall design and functioning of the buffer framework, (ii) missing or obsolete instruments, (iii) Internal Market considerations and (iv) global risks, including climate change. The response deals with each of these themes according to the following structure. First, it identifies the problem and the need for improvement. Second, a detailed assessment of the benefits and costs of each policy proposal is carried out to substantiate the proposals. The proposals put forward are based on a comprehensive literature review, with a focus on empirical evidence and Members States' experiences with the framework during the last few years.

In its call for advice, the Commission requested advice on improving the overall design and effectiveness of the buffer framework to prevent and mitigate financial stability risks and to reduce the procyclicality of the financial system. Chapter 1 discusses policy enhancements to the buffer framework. First, in order to enhance authorities' use of the countercyclical capital buffer (CCyB), the reply suggests adding additional cyclical indicators alongside the credit-to-GDP gap and allowing the CCyB to be activated based on signs of increasing cyclical risks. The early, preventive and forward-looking use of the CCyB strengthens resilience and ensures that there is enough capital that can be released or used for loss absorption during a crisis. In this context, the Capital Requirements Directive (CRD V)[1] should allow the option to reduce the 12-month implementation period to six months without the need to cite exceptional circumstances. Second, also with the purpose of enhancing the use of the macroprudential buffers, it is proposed that the amount of releasable capital be increased by (i) making earlier and more active use of the CCyB, (ii) enabling authorities to establish a positive neutral rate for the CCyB and (iii) enabling authorities to establish a positive neutral rate for the systemic risk buffer (SyRB). Third, it is important to address the interaction with minimum requirements to avoid constraints on the usability and effective use of capital buffers, while being consistent with global standards. A possible option for reducing the constraints is to mirror all macroprudential buffers, or at least the buffer for other systemically important institution (O-SII) as first step, in leverage ratio buffers to enhance consistency across banks and improve the usability of the buffer framework. Other options that eliminate or reduce the overlap problem are discussed in the ESRB (2021) report on the overlap between capital buffers and minimum requirements.

In its call for advice, the Commission requested advice on the need to add macroprudential tools to the EU legal framework and to reconsider whether some instruments have become obsolete. Chapter 2 discusses possible improvements to the macroprudential instrument framework. The first proposal is to introduce into the EU legal framework a minimum common set of borrower-based measures (BBMs) for residential real estate (RRE) while leaving in the hands of the national authorities the decisions on the activation and release of BBMs and on their calibration and overall design. The Commission should consider which safeguards might be necessary to ensure that the new set of macroprudential powers would be used solely at national level, as the proposal to include BBMs in EU legislation is subject to the condition that the topping-up power of the European Central Bank (ECB) does not apply. Such BBMs should also be included in the Mortgage Credit Directive (MCD)[2]. In addition, Member States should be allowed to extend the scope of BBMs to other loans and legal persons as a way of avoiding circumvention. In order to reduce the potential for inaction bias, common standards for the governance of BBMs should be introduced to increase transparency in decision-making about BBMs. However, in establishing minimum common definitions at European level, sufficient flexibility should be allowed in national definitions, including the flexibility to incorporate the measures of countries that have already activated BBMs. The creation of a minimum set of BBMs could be complemented by enhancing data availability, harmonising the monitoring indicators and addressing the existing gaps in the availability and comparability of data on the RRE and commercial real estate (CRE) markets in the EU by using the definitions of indicators set out in the ESRB Recommendation on closing real estate data gaps[3]. The second proposal is to consolidate all risk weight provisions currently in the Capital Requirements Regulation (CRR)[4] into a single article for exposures secured by immovable property, allowing only for interventions at the risk weight level.

In its call for advice, the Commission requested advice on whether the current macroprudential framework allows national authorities to adequately address systemic risk, ensuring both the effectiveness of the macroprudential instruments and the appropriate safeguards for the integrity of the Internal Market. Chapter 3 discusses possibilities for enhancing Internal Market consistency by simplifying procedures for the implementation and reciprocation of macroprudential measures. First, in order to reduce inaction bias and ensure the integrity of the Internal Market, it is crucial to revise the cumulative rule of broad and sectoral SyRB rates in the CRD V and clarify that recognised SyRB rates do not count towards the authorization thresholds. Second, this reply proposes simplifying the use of stricter national macroprudential measures under Article 458 of the CRR. The condition for activating Article 458 of the CRR should also take into account situations where the intensity of macroprudential or systemic risk is unchanged but still high, while the application period of Article 458 of the CRR and any subsequent extension should be increased by one additional year. The third proposal is to review reciprocity provisions by introducing a separate article outlining the scope of reciprocity of macroprudential measures. It is proposed to (i) adopt mandatory reciprocity for Article 458 measures and the SyRB, subject to materiality thresholds; (ii) remove the reciprocity cap of 2.5% for the CCyB; and (iii) adjust the procedural requirements (i.e. notifications). Fourth, the reply proposes to promote a holistic review of the O-SII identification and calibration methodology, for instance by developing an EU-wide floor methodology with additional guidance on the calibration of O-SII buffer rates. This should be accompanied by the use of within-year averages instead of year-end values during the O-SII identification process to reduce incentives to window dress.

The ESRB believes that ensuring cooperation, coordination and the exchange of information among microprudential and macroprudential authorities, resolution authorities and central banks enhances policymaking for the banking sector in particular and the financial sector as a whole, notably in a crisis. First, delineating the scope of action would streamline the governance procedures in macroprudential policy by helping identify synergies between the ESRB and the European Banking Authority (EBA). Whenever a new instrument or methodological approach is included in the EU macroprudential framework, the Commission should continue to ensure a prominent role for the ESRB. Second, the capital conservation plans, when defined and adjusted in the context of a systemic shock – and in particular where global systemically important institutions (G-SIIs)/O-SIIs are concerned, given the systemic importance of these banks – should also involve national macroprudential authorities, as the replenishment path and conditions should take into account broader financial stability considerations. In the event of a buffer breach, the competent authority should immediately inform authorities with a financial stability mandate. The competent authority should also consult the macroprudential authorities when deciding whether to impose distribution restrictions following a breach of the combined buffer requirement (CBR)/leverage buffer on top of the minimum requirement for own funds and eligible liabilities (MREL). Alternatively, distribution restrictions should be made automatic following such a breach. In addition, macroprudential and microprudential authorities should closely coordinate their decisions and timelines regarding the replenishment of buffers in the context of a systemic shock. Finally, the current review of the crisis management and deposit insurance (CMDI) framework in the EU should be used to ensure consistency with the macroprudential review, while potential amendments to the CRD/CRR package and the Bank Recovery and Resolution Directive (BRRD)[5] to address gaps in supervisory, MREL and resource data should be assessed by the Commission.

In its call for advice, the Commission requested advice on limiting systemic risks and vulnerabilities that do not necessarily originate in the EU banking system but affect European financial stability. Currently, macroprudential tools to prevent and mitigate financial stability risks arising from banks' exposures to third countries are considered appropriate and sufficient. In order to reduce the inaction bias when it comes to setting CCyB rates for exposures to third countries, it is therefore important that the ESRB's coordinating role is retained so that potential inconsistent application of the CCyB for third countries does not lead to fragmentation of the Single Market. Additionally, the process for activation of third-country measures could be reviewed in order to reduce inaction bias. The second proposal is to focus on the principle of "same activities, entity-specific risks, consistent rules" as overall guidance for reforming the EU macroprudential framework. In the longer term, a dedicated macroprudential code where the macroprudential framework is provided for the entire financial system would have several advantages. In the medium term, it is important to promote the implementation of measures to limit procyclicality in margin and haircut requirements, together with consistent macroprudential definitions of high-quality liquid assets (HQLA) across the financial system. More experience might be needed before introducing new harmonised liquidity instruments at EU level. However, that should not exclude the adoption of measures to promote a regulatory system-wide perspective for monitoring and addressing liquidity risks. In addition, with regard to liquidity regulation, it should be clarified that the CRD/CRR package does not prohibit additional liquidity instruments. Another proposal is to create capabilities to tackle climate risk by closing climate data gaps, developing harmonised and granular taxonomy and metrics. To ensure financial stability, the unique features and systemic dimensions of climate-related risks require the application of macroprudential policies consistent with and complementary to microprudential policy. The use of existing tools in the CRD/CRR such as the sectoral SyRB and large exposure limits should be explored. If the exploration shows that existing measures are insufficient to address climate risk the design of additional instruments like concentration charges in the framework could be considered. Finally, the reply proposes to extend the macroprudential mandate to include cyber resilience. This would make it possible to introduce elevated cyber resilience requirements for systemically important institutions and either apply concentration limits to third-party providers or require higher cyber resilience in the event of a lack of substitutability of third-party providers. The extension of the mandate should encompass third-party providers, in the same way as the Digital Operational Resilience Act (DORA) proposal[6] provides for a similar extension of the microprudential mandate. In addition, macroprudential authorities should be required to define their expectation as to a maximum acceptable level of disruption to critical economic functions which would not pose risks to financial stability. Meanwhile, efforts to supplement data collection initiatives with a framework for information sharing among authorities should be encouraged.

[omissis]

2. Obsolete and missing instruments

In its call for advice, the Commission requested advice on the need to add macroprudential tools to the EU legal framework or to reconsider whether some instruments have become obsolete, based on a cost-benefit analysis benchmarked against the baseline option of no change. This response focuses on four particular topics of interest.

- Many Member States are using BBMs in addition to capital-based and other measures to prevent credit-fuelled overheating. Should BBMs be added to the EU macroprudential toolkit? Specifically, how could the EU macroprudential framework support and ensure a more comparable and effective use of BBMs across Member States?
- There was a consensus in the current crisis on the need to impose restrictions on the distribution of capital to investors and staff even before the CBR is breached, but there are no clearly defined powers for national or EU authorities to apply such restrictions on a system-wide basis. Should competent authorities be empowered by EU law to impose restrictions on such distributions in exceptional circumstances (Article 518b of the CRR)?
- In particular, forthcoming legal changes due to the finalisation of Basel III reforms may have implications for macroprudential instruments that directly or indirectly affect risk weights such as those provided under Articles 164 and 458 of the CRR. To what extent should provisions be maintained that allow the adjustment of risk weights or risk weight determinants for real estate exposures on macroprudential grounds once Basel III input and output floors apply?
- Systemic liquidity risks have a cyclical component: in the boom phase, funding and market liquidity are abundant, and individual investors and issuers increase their liquidity risk exposure. This reduces their liquidity risk-bearing capacity, leading to increasing systemic liquidity risk throughout the financial system which may materialise when the liquidity illusion evaporates. The systemic consequences

of liquidity and funding risk call into question the desirability of creating new macroprudential liquidity instruments.

2.1 Borrower-based measures

(i) Reasons for improvement

BBMs act directly on the borrower, generally restricting the quantity of credit provided with characteristics that are deemed risky. The most frequently used measures are limits to loan-to-value (LTV), debt or loan-to-income (D/LTI), debt or loan-service-to-income (DSTI/LSTI) maturity and amortisation requirements. So far, existing measures have been predominantly used to address RRE risks, while a few measures to address risks related to CRE loans have also been implemented.[10] While powers to activate legally binding BBMs are currently available in most European Economic Area (EEA) countries, the existing national legal frameworks diverge significantly in the extent to which they are available to authorities to mitigate financial stability risks. Limitations on the use of appropriate macroprudential tools across Member States may expose the European economy as a whole to systemic risks. BBMs can help to ensure sound lending standards and higher resilience of borrowers. They are therefore necessary complements to capital-based measures. International experiences illustrate that risks to financial stability from developments on RRE markets tend to build up when there is a combination of strong house price growth and strong housing credit dynamics while credit standards are being eroded. BBMs can help mitigate these risks by ensuring minimum credit standards for new housing loans, which can be associated with stricter lending standards, a reduced risk of excessive mortgage credit growth and higher resilience of both households and lenders. By reducing the procyclicality of credit, the scale of banking crises and/or their negative economic consequences become smaller. Consumption and investment are less volatile, contributing to a more stable macroeconomic environment and facilitating economic growth in the medium term, particularly as borrowers are less at risk of not being able to repay or service their debt regularly without significantly reducing their consumption.

The availability of BBMs in individual countries depends on national legislation, and the definitions of the measures differ across countries. In many countries, the national legal frameworks provide a comprehensive set of legally binding BBMs, which the authorities can use depending on the vulnerabilities identified. However, in some Member States, either legally binding BBMs are missing completely (Greece, Poland[11]) 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). Both the definitions and the design of the measures in place also vary across the EEA countries. 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.

(ii) Proposals for enhancement

- Enhance the EU macroprudential framework by introducing BBMs for new RRE loans into EU law (the CRD and MCD). To ensure (i) that the scope of BBMs is at least the same as that of capital-based measures, while at the same time extending the scope of BBMs to non-banks; and (ii) that they apply to credit granted by EU branches, it would be recommended that reference be made to BBMs in both legal texts, the CRD and the MCD. This would not only ensure a level playing field but would also prevent regulatory arbitrage.

- Make a minimum but sufficient set of BBMs for RRE loans available in all countries, with the aim of mitigating risks related to RRE markets effectively, both at national level and at EU level.
- Keep decisions both on the activation and the release of BBMs and on their calibration and overall design solely in the hands of national authorities. In addition, entrust either designated authorities or macroprudential authorities with an active role in making decisions on BBMs.
- Define BBMs using general principles from the ESRB Recommendation on closing real estate data gaps but ensure that definitions are flexible and that BBMs are used throughout the EU. The flexibility is required so that national specificities and circumstances can be addressed and the effectiveness of BBMs is ensured.[12]
- Introduce basic common standards for the governance of BBMs in order to reduce the potential for inaction bias by increasing transparency in the decision-making on BBMs.
- Make BBMs applicable, at a minimum, to new RRE loans provided to natural persons, while allowing national legal frameworks to extend their applicability to other consumer loans and legal persons. The broader scope would prevent circumvention of BBMs and increasing indebtedness of mortgagors.
- Enhance data availability and harmonise the definitions related to RRE and CRE loans across EU reporting by making use of the work on the ESRB Recommendation on closing real estate data gaps. This would not prevent countries from continuing to collect more detailed data for decision-making about BBMs using national definitions.

(iii) Policy assessment

Including BBMs for RRE loans in the EU macroprudential framework would, if appropriately designed, have the potential to bring significant benefits; these benefits could include, for instance, increasing effectiveness in mitigating RRE-related systemic risks at EU level and enshrining BBMs as standard macroprudential instruments along with capital-based measures. Although both legally binding and non-legally binding BBMs are already applied in most Member States, the inclusion of a common minimum toolbox of BBMs in EU legislation would enhance the EU macroprudential framework by ensuring that a sufficient set of borrower-based instruments was available and could be used by the authorities of all EU Member States to prevent the build-up of systemic risks. At the same time, including BBMs in the CRD would complement the existing set of macroprudential instruments for the banking sector and emphasise the financial stability dimension of BBMs alongside the existing capital-based measures. By contrast, the inclusion of BBMs in the MCD, which is also aimed at contributing to financial stability, would allow authorities to apply macroprudential BBMs to loans granted by all types of lenders, including insurance companies and investment funds.

It would be beneficial to refer to BBMs in both legal texts, the CRD and the MCD, to ensure that the scope of BBMs mirrors that of capital-based measures, to extend the scope of BBMs to non-banks and to ensure that BBMs apply to credit granted by EU branches. To ensure that BBMs are applied at the same level as capital-based measures, but at the same time to extend the scope of BBMs to EU branches and non-banks, it would be important to refer to the macroprudential use of BBMs in both legal texts, the CRD and the MCD. In addition, Member States would not be precluded from applying BBMs to other types of loans granted to borrowers, e.g. to consumer loans. Although the proposal is not intended to harmonise BBMs at EU level, it could lead to a further alignment of national legal frameworks and reduce the complexity arising from the multitude of different national legal frameworks across the EU.

In addition, the inclusion of BBMs in EU legislation could reduce risks related to an inaction bias potentially associated with the use of BBMs. The proposal could increase the transparency and comparability of macroprudential actions across Member States and thus strengthen overall confidence in the measures. To that end, the EU legal framework should be designed in such a way that it is not in conflict with existing national macroprudential frameworks for BBMs. Should that be the case, the benefits of including BBMs for RRE loans in the EU macroprudential framework are expected to significantly outweigh the associated efforts in terms of the necessary adaptation and transposition at Member State level. By contrast, should the design of an EU legal framework require changes other than including the minimum set of BBMs in the existing national frameworks for BBMs developed over the past decade, this could also entail potential additional costs. These would not just be procedural and could affect the cost-benefit calculus of the proposal.

The EU legal framework should take into consideration a minimum basis for BBMs but ensure sufficient flexibility for Member States. The EU legal framework should be enriched by a minimum but sufficient set of BBMs available in all countries to mitigate risks related to RRE markets. EU legislation should define the key concepts for BBMs at EU level but leave flexibility to Member States on specific elements of the definitions and indicators of lending standards used by national authorities for making decisions about the activation, release and calibration of BBMs. This flexibility is needed to account for national specificities and ensure that BBMs remain effective. Following the principle of proportionality, changes to existing national frameworks should not be required if the frameworks already meet the requirements set out in the EU framework. However, establishing the minimum set of BBMs for RRE at EU level should allow enough flexibility for national definitions to incorporate the measures of countries that have already activated BBMs.

The BBMs should remain solely at national level, and the Commission's legislative proposal should provide for sufficient safeguards to ensure that national authorities are in charge of BBMs. The decision about the activation, calibration and lifting of BBMs should remain the full responsibility of Member States and their authorities. In addition, the Commission should consider which safeguards would be necessary to ensure that the new set of macroprudential powers would be used solely at national level, as the proposal to include BBMs in EU legislation is subject to the condition that the ECB's topping-up power does not apply. Either the designated authorities or the macroprudential authorities should be entrusted with an active role in activating and calibrating BBMs, as it is essential for the application of BBMs to involve authorities with sufficient experience in addressing financial stability risks stemming from the RRE market. BBMs should, at a minimum, be applicable to new RRE loans taken out by natural persons. However, to avoid increasing the indebtedness of mortgagors and to prevent measures from being circumvented, EU legislation should, where appropriate, allow national legal frameworks to have the possibility of applying BBMs to other consumer credit and/or to legal persons. In addition, it should be mandatory for all institutions involved in making decisions on the activation, release and calibration of BBMs to regularly assess

(i) any potential sources of systemic risk stemming from the RRE markets and (ii) the need to act using macroprudential measures and BBMs in particular. The main observations from the assessments of vulnerabilities conducted by the relevant authorities should be made transparent, for instance in a regular financial stability publication or other dedicated publication. Box 1 summarises the main features of the proposal for including BBMs in EU legislation.

As well as including BBMs in EU legislation, definitions relating to RRE and CRE loans used for the monitoring of risks in the current EU reporting could be harmonised. Currently, some of the reporting requirements use definitions which are consistent with the ESRB Recommendation on closing real estate data gaps, while others use different (previously set) definitions. Harmonising the definitions in the reporting at EU level would therefore reduce costs to lenders, make it easier to monitor risks to financial stability across Member States and thus foster the further development of BBMs as an effective and efficient tool for addressing vulnerabilities stemming from the real estate markets. However, Member States should be able to continue using different indicators for the purpose of activating, releasing or calibrating BBMs if that is necessary owing to national specificities. At the same time, further work needs to be done on closing the prevailing data gaps, especially in relation to CRE loans. This could be done by further developing and improving data collection through the AnaCredit dataset or other credit registers.

BOX 1: **PROPOSAL FOR INCLUDING BBMS IN EU LEGISLATION**

A minimum set of BBMs for RRE should be included in EU legislation, applying the BBMs to natural persons and potentially – in accordance with national frameworks – also to legal persons. The proposal envisages a common basis for BBMs but it also ensures that Member States are left with sufficient flexibility. EU legislation should define the key concepts for BBMs at EU level but Member States should have flexibility over specific elements of the definitions and indicators of lending standards used by national authorities in decision-making with regard to the activation, release and calibration of BBMs.

To ensure that BBMs are applied with the same scope as capital-based measures for banks, while at the same time extending the scope of BBMs to non-banks, it would be most effective to refer to BBMs in both legal texts (the CRD and the MCD), despite the existing differences between the regulatory objectives of the CRD and the MCD.

The design, calibration and activation of BBMs would remain solely at national level and the Commission should provide for the implementation of sufficient safeguards to ensure that the national authorities are responsible for BBMs. Member States and their authorities remain fully responsible for any decision to activate BBMs. However, it would also be strongly advisable to entrust the designated or macroprudential authorities with an active role in the activation and calibration of BBMs as it is essential, with regard to the application of BBMs, to involve authorities with sufficient experience of addressing the financial stability risks stemming from the RRE market.

Furthermore, to reduce the number of potential sources of inaction bias, a regular assessment of the need to act using BBMs should be made mandatory for all national authorities entrusted with decision-making in respect of BBMs. The main observations from the assessments of vulnerabilities conducted by the relevant authorities should be made transparent (e.g. in a part of the regular financial stability publication or in another dedicated publication).

In addition to the key elements of BBMs, EU legislation should also include an ex post reporting obligation to inform the ESRB of the activation/setting of BBMs, although it should not require an authorisation procedure prior to the activation of BBMs.

1. The inclusion of BBMs in EU legislation. Introducing BBMs into EU law, thereby enhancing the macroprudential toolkit available to all EU Member States, would be an important step towards strengthening Member States' ability to contain systemic risk related to RRE markets across the EU. This could be achieved by establishing a common basis for BBMs at EU level and facilitating the coordination of national measures to activate or set BBMs. However, the proposal does not intend to establish uniform and directly applicable prudential requirements for credit institutions in the area of lending for the financing of RRE. Instead, it seeks to ensure accountability and transparency, as well as to allow for better comparability in the activation and definition of BBMs at national level.

To ensure that the scope of BBMs is at least the same as that of capital-based measures, and at the same time to extend the scope of BBMs to non-banks, it would be more effective to refer to BBMs in both legal texts, the CRD and the MCD. Including BBMs in the CRD would complement the existing set of macroprudential instruments for the banking sector and emphasise the financial stability dimension of BBMs alongside existing capital-based and other measures, while including BBMs in the MCD would allow the authorities to apply BBMs to loans granted by all types of lenders, including insurance companies, investment funds and pension funds. In addition, Member States should be allowed to extend the scope of BBMs to other consumer loans to avoid circumvention. This would ensure a level playing field and prevent regulatory arbitrage.

2. Types of instrument. The proposal is to incorporate a minimum set of instruments for BBMs into European law. EU legislation should provide for several BBMs to address the risks to financial stability stemming from the RRE market. The BBMs to be incorporated into EU legislation should be, at a minimum, the following:

(a) limits that apply to the debt-to-income (DTI) ratio and limits that apply to the debt service-to-income (DSTI) ratio;

(b) limits that apply to the loan-to-value (LTV) ratio;

(c) limits that apply to the maturity;

(d) amortisation requirements.

These instruments are regarded as the minimum set of tools, and it should be ensured that they are available to help mitigate systemic risk, in line with international experience of BBMs. Member States should feel encouraged to go beyond this set of tools or to allow full flexibility to the respective authorities to use any macroprudential instruments related to the loan or borrower characteristics of RRE loans. Legal frameworks for BBMs, which give flexibility to the national authorities in terms of instruments that can be activated (i.e. national legal frameworks that allow for the activation of the aforementioned BBMs without listing them explicitly) should be considered to be compliant with this requirement.

In addition to making it possible to apply this set of instruments in a legally binding manner, EU legislation should explicitly allow Member States the flexibility to adapt the details (e.g. definitions), of these instruments to their national macroprudential policy needs (e.g. taking into account the specific characteristics of their national RRE market) and to add further instruments to their respective toolkits[13]. Also, in line with the principle of proportionality, Member States should be able to activate non-legally binding limits if this is deemed more appropriate in a specific situation. More specifically, Member States should therefore also be able to introduce non-legally binding BBMs by issuing macroprudential expectations. Such a possibility could either be included in EU legislation or could be an element of guidance to be issued by the ESRB in the form of recommendations.

3. Definitions of indicators. EU legislation should describe the general principles and concepts of the BBMs, leaving further details of the definitions of the BBMs to Member States, and should contain a reference to the definitions in the ESRB Recommendation on closing real estate data gaps[14]. This recommendation is particularly suitable as a starting point for establishing certain definitions of general aspects of BBMs at European level, as it has been prepared while taking into account ongoing international and European initiatives in the area of data harmonisation and collection. Although the definitions of the indicators to be used to monitor risks stemming from the RRE market should follow the aforementioned ESRB Recommendation, it should be possible to make national modifications, especially when the indicators are used in the monitoring of risks as well as the activation and calibration of BBMs at the national level. This ensures that Member States that have already activated BBMs have a level of flexibility that enables them to continue to use their current definitions of indicators at national level. To provide for sufficient flexibility at Member State level, the proposal to include BBMs at EU level would therefore not include any detailed definitions and methods for calculating indicators for BBMs such as those specified in Annex IV of the ESRB Recommendation. At this stage, detailed harmonisation of the definitions of indicators to be used in BBMs at EU level would be counterproductive in respect of the broader acceptance of BBMs and their potential use. However, Member States should be encouraged to follow the definitions specified in Annex IV of the ESRB Recommendation as closely as possible when introducing new BBMs or when amending the legal framework applicable to BBMs, if this is in line with their national specificities.

An example of the inclusion of the definition of a BBM (DTI) in EU legislation based on the ESRB Recommendation on closing real estate data gaps:

“A DTI instrument should be defined as limits to or requirements of debt-to-income ratio, which means the total debt of the borrower at the moment of loan origination relative to the borrower’s total annual income at the moment of loan origination.”

Apart from the definition of income as “total annual income”, the proposal would not contain any other elements of income definition. In particular, it would not include the first-best definition of “disposable income” described in Annex IV of the ESRB Recommendation on closing real estate data gaps.

4. Governance. The Commission's proposal should clearly assign the responsibility for activating and calibrating BBMs to national level, and should explicitly rule out any topping-up powers for European authorities or institutions. Member States and their authorities remain fully responsible for the decision to activate, release and calibrate BBMs. However, the designated or macroprudential authorities should be entrusted with an active role in the activation and calibration of BBMs, as it is essential for the application of BBMs to involve authorities with sufficient experience of addressing the financial stability risks stemming from the RRE market. Furthermore, the regular monitoring of the risks stemming from the RRE market is essential for the supervision of the financial system and the prevention or mitigation of systemic risks to financial stability. The main observations from the assessments of vulnerabilities conducted by the relevant authorities (those entrusted with assessing systemic risk as well as those entrusted with the activation of BBMs) should be made transparent in, for example, a regular financial stability publication or in another dedicated publication. Conferring tasks associated with the monitoring of risks on macroprudential authorities should be in line with the mandates of national macroprudential authorities, as required by the ESRB in its Recommendation on the macroprudential mandate of national authorities15. The additional burden on macroprudential authorities would therefore be limited. In addition, the ESRB may always issue recommendations addressed to Member States that do not take appropriate action in response to risks to financial stability.

Furthermore, the requirement for cooperation, coordination and exchange of information between national authorities (including the designated or macroprudential authorities), as well as between national and EU authorities, should be a key element of the proposal to establish a common minimum toolbox of BBMs at EU level.

5. Flexibility in the use of BBMs. When transposing BBMs into national legal frameworks, Member States should be required to provide for the possibility of activating legally binding instruments so that such instruments may be effectively and efficiently used to avoid the build-up of vulnerabilities. Based on appropriateness, sufficiency and proportionality, Member States' authorities should, however, have the possibility of deciding if those instruments are activated in a legally or non-legally binding manner.

In particular, national authorities should be able to:

(i) activate the BBMs pre-emptively to avoid the build-up of vulnerabilities;

(ii) activate one or more BBMs at the same time, possibly in combination with other macroprudential instruments such as capital buffers;

(iii) activate BBMs in a conditional form (e.g. by applying an LTV limit or amortisation requirement to loans that do not comply with certain DSTI limits);

(iv) activate different instruments, or calibrate the same instruments differently, depending on distinct specific borrower or loan characteristics (e.g. by applying less stringent LTV limits to first-time buyers);

(v) define exemptions from the BBMs (e.g. by allowing a certain percentage of loans to be provided in breach of LTV limits or exempting certain product types altogether).

6. Conditions to be met for activation, release and calibration. The conditions to be met for the activation of or changes to BBMs should be set exclusively by Member States. To further ensure consistency the ESRB could develop a framework providing guidance to national authorities on issues such as the activation, release and calibration of BBMs as well as the principles behind the monitoring of risks related to RRE. This would promote sound and consistent decision-making across Member States, while any policy decision regarding the use of BBMs would remain explicitly with the Member States. Furthermore, BBMs should not be included in the so-called pecking order of macroprudential measures (i.e. capital buffers as well as risk weights and other measures) given their different yet complementary nature and their differing objectives and transmission channels. Decisions about the activation of BBMs and the right mix of borrower-based and capital-based measures in place should follow careful assessment of the nature and intensity of the vulnerabilities.

7. Methodologies. Member States should preferably apply a methodology, established by each Member State, when assessing and monitoring risks and when calibrating BBMs. The ESRB would be available to assist them in developing such a methodology, for instance issuing a recommendation based on the "guided discretion" approach. This approach could provide guidance on the assessment of interactions between the envisaged BBMs and other macroprudential tools, such as capital-based measures. In addition, the ESRB could facilitate discussions among Member States, as well as with the European institutions, on the setting of BBMs.

8. Ex post reporting of the measures. There should be no authorisation requirements for activating or setting BBMs. Although EU legislation should not provide for any authorisation procedure it should, however, include an ex post obligation for Member States to report to the ESRB on the activation/setting of BBMs. To promote the further transparency and comparability of national measures it would also be beneficial to include an explanation of the activated measures and to accompany the reporting with reasons for the activation, release or calibration of BBMs. There could also be an obligation to include an explanation as to why the measure is considered suitable, effective and proportionate to address the situation. The ESRB would be able to assess the proposed measures, looking at both the benefits of the macroprudential measures from a national financial stability perspective and potential spillover effects. The reporting obligation would also allow the ESRB to contribute to a further deepening of coordination between the authorities involved by developing a coherent and consistent macroprudential policy framework in the EU and by promoting best practices.

9. Reciprocity. Ensuring the reciprocation of national measures is an important part of creating a level playing field for lenders. In principle, reaching a common understanding of the BBMs at EU level should pave the way for the implementation of provisions on reciprocation.

10. Disclosure. The relevant authority should publicly announce the activation and setting of the BBMs (including the assessment of appropriateness and other relevant background information) through the usual communication channels (such as websites) used for other macroprudential measures.

11. Transitional period. The proposal would not lead to the existing national measures being discontinued, as it does not alter the existing national frameworks for BBMs that already include the proposed set of instruments and, in principle, allow national authorities to activate legally binding instruments. However, some Member States would need to adjust their legal frameworks if these did not include the possibility of activating the full set of instruments in a legally binding manner. In order to keep transition costs low and to avoid too much interference with existing national frameworks, especially for national measures based on such national frameworks, the proposal to include BBMs at EU level would also provide for a sufficient transition period.

[omissis]

[1] Directive (EU) 2019/878 of the European Parliament and of the Council of 20 May 2019 amending Directive 2013/36/EU as regards exempted entities, financial holding companies, mixed financial holding companies, remuneration, supervisory measures and powers and capital conservation measures (OJ L 150, 7.6.2019, p. 253).

[2] 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 (OJ L 60, 28.2.2014, p. 34).

[3] 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).

[4] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p. 1).

[5] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (OJ L 173, 12.6.2014, p. 190).

[6] Proposal for a Regulation of the European Parliament and of the Council on digital operational resilience for the financial sector and amending Regulations (EC) No 1060/2009, (EU) No 648/2012, (EU) No 600/2014 and (EU) No 909/2014 (COM/2020/595 final).

[10] So far, only Denmark has imposed restrictions on the exposures of credit institutions to CRE, while Cyprus and Poland have introduced LTV limits for CRE loans.

[11] In Poland, BBMs have been used as part of supervisory guidance to banks since 2010 (DSTI), 2013 (maturity limits) and 2014 (LTV). Banks have been following those guidance in their lending policies.

[12] This includes flexibility on making decisions about the introduction of BBMs by means of legally or non-legally binding regulation.

[13] Depending on the availability in each country of data on individual borrowers and their overall debt in each country, limits to loan-to-income (LTI) and loan service-to-income (LSTI) should be considered to be available in the national toolkit for BBMs.

[14] See Recommendation of the European Systemic Risk Board of 31 October 2016 on closing real estate data gaps (ESRB/2016/14) (as amended by Recommendation ESRB/2019/3).

[15] Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3) (OJ C 41, 14.2.2012, p. 1).

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