Macroprudential Policy: A Complementing Pillar in Prudential Supervision – The EU and Austrian Frameworks

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There have been remarkable developments in the field of macroprudential supervision in the European Union (EU) and Austria since the onset of the financial crisis: The European Systemic Risk Board (ESRB) has established itself as an important shaper of macroprudential policy in the EU. In response to one of the ESRB's recommendations, the vast majority of EU Member States have set up, or are about to set up, national macroprudential authorities. The newly introduced EU banking legislation explicitly provides supervisors with prudential instruments designed to address systemic risks. In Austria, as of 2014 the Financial Market Stability Board (FMSB) will be the central body for the coordination of macroprudential policy. The legal mandate of the Oesterreichische Nationalbank (OeNB) was amended to include various new macroprudential tasks for the supervision of banks, in particular, but also regarding systemic risks associated with the use of leverage by alternative investment funds. In its capacity as either competent or designated authority, the Financial Market Authority (FMA) is the prudential authority in charge of implementing macroprudential policies.

The challenges ahead – besides methodological issues not addressed in this paper – include (1) ensuring the effectiveness of the new institutional arrangements in overcoming the inaction bias inherent in macroprudential policy, (2) managing the notification and approval requirements in the area of macroprudential instruments as set out in EU banking law, and (3) coordinating cross-border effects of national macroprudential policies.

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Since the more fundamental macroprudential policy issues were discussed in Financial Stability Report 21 (Liebeg and Posch, 2011), considerable progress has been made in establishing a framework for macroprudential measures in the EU and Austria alike. This paper describes this new framework as well as its key players and their mandates, and concludes with an outlook on the challenges ahead.

Macroprudential policy aims at modifying the key prudential parameters, such as capital, liquidity or concentration risk requirements, to reflect the changes in the systemic risk environment related inter alia to the macroeconomy, the financial system or individual institutions in a forward-looking manner, taking into account both the time-varying and the structural dimension of systemic risk.

1 ESRB Makes Important Contribution to the EU Supervisory Landscape

Since its establishment in 2011, the European Systemic Risk Board (ESRB) has issued six recommendations on financial stability issues, which are governed by an "act or explain" mechanism, i.e. addressees – national supervisors and EU governments as well as the European Commission and the European System of Financial Supervisors (ESFS) – are either to implement

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these recommendations or offer an appropriate justification in case of inaction. In doing so, the ESRB takes a comprehensive approach with a focus that goes beyond the banking sector. Four of the six ESRB recommendations address systemic risks: the recommendations on foreign currency lending (ESRB, 2011a), U.S. dollar-denominated funding (ESRB, 2011b), money market funds (ESRB, 2012a) and the funding of credit institutions (ESRB, 2012b).

Besides addressing systemic risks, the ESRB also aimed to improve the macroprudential oversight framework in the EU by issuing a recommendation on the macroprudential mandate of national authorities in 2011 (ESRB, 2011c) and a recommendation on intermediate objectives and instruments of macroprudential policy in 2013 (ESRB, 2013). The former recommendation, which addressees had to comply with by June 2013, advised EU Member States to establish national macroprudential authorities with a specific mandate to contribute to financial stability in the respective Member State. Most EU countries have established such a body or have expressed the intention of doing so. However, the concrete institutional arrangements vary across countries. In some cases the national central banks have a leading role (as envisaged by the recommendation), whereas in other cases the ministries of finance play a more prominent part in the macroprudential body. The latter recommendation (ESRB, 2013) builds on the former and, by proposing intermediate objectives for macroprudential policy and appropriate instruments to address them, provides guidance on how to operationalize the macroprudential mandates. Finally, in the course of 2013, the ESRB has worked on making the macroprudential instruments proposed in its latest recommendation operable.

2 Macroprudential Tools Provided by the New EU Banking Legislation

The new European banking legislation, i.e. Directive 2013/36/EU[2] (Capital Requirements Directive IV – CRD IV) and Regulation (EU) No 575/2013[3] (Capital Requirements Regulation – CRR), acknowledges that in safeguarding financial stability, macroprudential policy is a necessary complement to traditional microprudential supervision. It also recognizes that systemic risks may differ across EU Member States, reflecting for example differences in the structure and size of the banking sector compared to the wider economy and the credit cycle, and that it is, therefore, essential for national authorities to be able to address such national specificities effectively. For this reason, the new legislation on the one hand establishes uniform microprudential rules ("a single rule book") for the institutions covered and on the other hand affords national authorities a leading role – and some degree of flexibility – in respect of their macroprudential policies. This approach correctly reflects the different sources and the complex nature of systemic risk as well as the expertise and responsibilities of prudential authorities in relation to financial stability at the national level. This is designed to foster both financial stability in the EU and the smooth functioning of the internal market.

The new EU banking legislation provides banking supervisors with a

[2] *Official Journal (OJ) L 176, 27.6.2013, p. 338.*

[3] *OJ L 176, 27.6.2013, p. 1.*

number of legally binding instruments designed to address different dimensions of systemic risk to financial stability. Within the CRD framework, supervisory authorities will have a combined buffer requirement at hand, including a countercyclical capital buffer, a buffer for systemically important institutions and a systemic risk buffer. This macroprudential buffer regime allows for an adaptation of banks' capital base in response to developments in the financial system or the macroeconomy. It also provides for a differentiated approach to addressing the two main dimensions of systemic risk, the time dimension and the cross-sectional dimension. For instance, the countercyclical capital buffer should be built up when aggregate growth in credit and other asset classes is judged to be associated with a build-up of system-wide risk, taking into account the ratio of credit to GDP in individual Member States, and can be reduced during periods of stress. However, the buffers designed for systemically important institutions and against overall systemic risks can be used as a measure against more structural risks to financial stability. In addition, the overhaul of the pillar 2 framework and the regime of supervisory power will enable the competent authorities to take the assessment of systemic risk into account in prudential supervision.

Laying down uniform rules concerning prudential requirements for banks, the CRR also includes discretionary elements that can be used by the authorities to tackle specific systemic risks. This applies particularly to financial stability concerns regarding mortgage exposures. Supervisors can respond to risks from real estate markets by adapting risk weights and exposure-weighted average loss-given-default values accordingly.

If none of these measures are deemed to be adequate for addressing the identified systemic risks, authorities can adopt additional macroprudential measures in the context of several harmonized prudential requirements, including the level of own funds, sectoral capital requirements, liquidity requirements and the rules concerning large exposures and public disclosure. However, this additional flexibility is available only for a limited period of time and subject to procedural controls involving European institutions and bodies, including the European Commission and the Council, in order to safeguard the internal market. The macroprudential framework of EU banking legislation includes rules on the mutual recognition of national macroprudential policies.

3 The Single Supervisory Mechanism: An Additional Institutional Layer in the Macroprudential Policy Framework

The implementation of the single supervisory mechanism (SSM), which grants the European Central Bank (ECB) supervisory powers over banks in the euro area and in opt-in Member States, adds an institutional feature to the macroprudential policy framework. While macroprudential policy remains primarily the competence of Member States – thereby honoring the fact that national financial cycles may vary between countries – the SSM Regulation[4] also provides the ECB with certain competences in the field of macroprudential supervision: If deemed necessary, the ECB may – within the scope of the SSM and instead of the national

[4] *OJ L 287, 29.10.2013, p. 63.*

authorities – impose higher capital buffer requirements or apply other stricter measures aimed at addressing systemic risks at the level of credit institutions in the cases specifically set out in EU banking legislation. For the purposes of SSM banking supervision, the ECB is deemed to be the respective competent or designated national authority. In this way, there is an extra layer of protection against a potential "bias towards inaction" (ESRB, 2011c) in macroprudential supervision. The ECB and the national authorities are obliged to cooperate closely and to mutually notify each other at least ten days in advance of any decisions regarding the use of macroprudential policies.

4 A Macroprudential Perspective to AIFM Oversight

The European Alternative Investment Fund Managers (AIFM) Directive[5] came into force in mid-2011. The Directive was transposed into Austrian law through the Alternatives Investmentfonds Manager-Gesetz (AIFMG)[6], which entered into force on July 22, 2013. It is comprehensive in scope, covering all managers of funds that are not subject to the Units for Collective Investment in Transferable Securities (UCITS) Directive. This includes inter alia managers of hedge funds, private equity funds and closed-end funds. The AIFM Directive is designed to improve supervision of the shadow banking sector in Europe. The introduction of comprehensive reporting requirements for such fund managers made extensive supervisory data on non-UCITS funds and their managers available to supervisors for the first time. If deemed necessary from a financial stability perspective, supervisors may also require supplementary information. Article 25 of the AIFM Directive introduces a macroprudential perspective to securities supervision: Supervisory authorities are required to use supervisory data for assessing whether the use of leverage by AIFMs contributes to the build-up of systemic risk in the financial system, risks of disorderly markets or risks to long-term economic growth. Furthermore, the authorities have to assess whether AIFMs or their funds potentially constitute an important source of counterparty risk to a credit institution or other systemically relevant institution in another Member State. Article 23 AIFMG mandates the OeNB to conduct analyses of the respective systemic risks to financial stability. Any financial stability concerns identified by the OeNB must be reported to the FMA, which, as competent authority, may impose limits on the level of leverage allowed to AIFMs or issue other restrictions.

5 The Newly Established Austrian Financial Market Stability Board

In compliance with the ESRB recommendation on national macroprudential mandates, the Austrian legislator has established the Financial Market Stability Board (FMSB, Finanzmarktstabilitätsgremium). Article 13 of the "Finanzmarktaufsichtbehörden-Gesetz" (FMABG)[7] lays down the mandate and composition of the FMSB, which will take up operations in 2014. The FMSB's tasks will be strengthening financial stability, mitigating the risks of systemically important financial institutions and addressing the structural and cyclical aspects

[5] *OJ L 174, 1.7.2011, p. 1.*

[6] *Federal Law Gazette I No. 135/2013.*

[7] *Federal Law Gazette I No. 184/2013, Article 7.*

of systemic risk. The FMSB consists of six members: two representatives of the Federal Ministry of Finance, which also chairs the board, two representatives of the newly established Fiscal Advisory Council and one each of the FMA and the OeNB.

Mimicking the "act or explain" framework of the ESRB, the Austrian setting provides for instruments in the form of recommendations the FMSB may address to the FMA, which will either implement them or explain non-action or any other deviation from the FMSB's recommendations. According to the revised Austrian Banking Act[8], the FMA is the designated authority for macroprudential instruments for which CRD IV or CRR require such a designation (i.e. capital conservation buffer, countercyclical capital buffer, buffers for Global Systemically Important Institutions (G-SII) and Other Systemically Important Institutions (O-SII), systemic risk buffer and the instruments of Article 458 CRR[9]). These instruments are implemented by the FMA through administrative regulations ("Verordnungen"), with the exception of the G-SII and O-SII buffers, which are implemented by individual decisions ("Bescheide"). In all cases, the FMA has to obtain the approval of the Federal Ministry of Finance as a final condition before enacting such legal acts.

Besides its representation in the FMSB, the OeNB, according to Article 44c of the amended Federal Act on the Oesterreichische Nationalbank (Nationalbank Act)[10], plays an important role in contributing to macroprudential policy in Austria. The legal mandate of the OeNB comprises identifying systemic risks, informing the FMSB of its findings, proposing recommendations and risk warnings the FMSB may then issue to the FMA, assessing the implementation of the FMSB's recommendations and preparing an annual report on the systemic risk situation in Austria for the FMSB's annual report to Parliament and the Federal Ministry of Finance. Finally, the FMSB will be administered by a secretariat established at the OeNB.

6 Conclusions

While the macroprudential policy framework in the EU and Austria now rests on a more solid footing than before, there is still the challenge of addressing specific systemic risks to financial stability using concrete macroprudential policy measures that are effective, efficient and proportional, yet timely. These challenges can (roughly) be attributed to two spheres: the methodological and the institutional sphere.

The methodological issues – which are not the main focus of this paper – center on identifying appropriate indicators that give early warning signals ahead of a looming crisis, designing appropriate tools for addressing the risks identified and getting a grip on the intended and unintended consequences of these instruments.

When it comes to the institutional aspects of macroprudential policy, there are three main types of challenges:

First, the institutional arrangements setting up the macroprudential frame-

[8] *Federal Law Gazette I No. 184/2013, Article 2.*

[9] *The instruments of Article 458 CRR consist of amendments to the level of own funds, requirements targeting large exposures, public disclosure requirements, level of the capital conservation buffer, liquidity requirements, risk weights for targeting asset bubbles in the residential and commercial property sector or intrafinancial sector exposures as regulated in CRR.*

[10] *Federal Law Gazette I No. 135/2013.*

work in response to the ESRB recommendation will have to prove that they are effective in coordinating macroprudential policies to address systemic risks and in overcoming the potential bias toward inaction inherent in the macroprudential policy setting, which is typically accompanied by visible short-term costs but invisible longer-term benefits. Furthermore, the successful development and implementation of macroprudential policies requires intensive and transparent cooperation and interaction between the micro- and macroprudential perspectives of supervision.

Second, the measures provided by the new EU banking legislation are subject to (varying) notification and approval requirements by the EU institutions (e.g. the European Banking Authority, the ESRB, the European Commission, the EU Council and the European Parliament). Some of these coordination procedures at EU level are rather burdensome and could, thus, induce a certain level of inaction bias or result in the use of second-best solutions in macroprudential policy.

Third, cross-border considerations have to be taken into account as some measures may have spillover effects, e.g. in cases in which banking systems are dominated by foreign owners (the host country may be affected by measures taken in the home country) or in which banks have considerable foreign operations (the home country being affected by measures taken in host countries). While the EU framework provides for coordinative platforms between the different EU Member States, coordination with non-EU countries will need to rest on informal agreements. In this respect, the Vienna 2.0 Initiative could provide for an adequate platform if set up properly.

Another aspect shaping macroprudential policy in the euro area is the newly introduced SSM that establishes the ECB, together with the respective national authorities, as banking supervisor with both micro- and macroprudential competencies. Here, the overlaps and complements of the ESRB, the ECB and national authorities will yet have to be worked out.

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