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Macroprudential policy and its relationship with monetary policy: the complex European framework

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Monetary Policy Workshop

Brussels
January 18, 2016

What is financial stability?

- **Systemic risks in financial systems arise if distress in one institution or a group of financial institutions threatens the functioning of the entire financial system:**
  - **Domino effects** due to direct contractual linkages
  - **Informational contagion** leading to runs on assets of other financial institutions, even without any direct contractual linkages
- **A financial system is all the more stable …**
  - … the **less distorted** investment decisions are and
  - … the **stronger risk buffers** and capitalization of financial institutions.

➢ **Macroprudential policy aims at strengthening the resilience of the financial system and at reducing systemic risks.**

Macroprudential policy-making takes place under a high degree of uncertainty.

- **Most macroprudential instruments are new and largely untested.**
  - What are appropriate objectives and (intermediate) policy targets?
  - What data are needed for the surveillance of financial stability?
  - Which theoretical models guide policymaking?

- **This uncertainty entails risks …**
  - … of an inaction bias and the quest for "more data" and "more analysis".
  - … of (ab)using macroprudential policies for other policy purposes.

➢ **A clear strategy for (ex-post) policy evaluation is needed.**

Unlike monetary policy, a well-defined policy cycle for macroprudential policy has yet to be established.

- **Establishing such a policy cycle requires**
  - Availability of data: Needs to be planned *before* the measure is implemented
  - Quantification of policy target(s): Map indicators into measurable targets
  - Identification of intermediate objectives (e.g. credit growth)
  - Assign instruments to objectives (e.g. liquidity ratios, capital buffers, risk weights) **(Ex ante evaluation)**
  - **Ex-post evaluation** (based on pre-specified policy objectives)

In June 2015, the German Financial Stability Council recommended new housing-related instruments.

- **Regulation of the real estate markets is under national responsibility.**
- **Proposed instruments apply to residential real estate: Reduce the probability that losses materialize and improve the ability to absorb losses.**
  - Loan-to-Value Ratio (LTV)
  - Debt-to-Income Ratio (DTI)
  - Debt-Service-to-Income Ratio (DSTI)
  - Amortization requirements
- **Recommendation foresees ex post evaluation ("impact analysis")**
  - Compulsory, two year interval (upon activation)
  - Conducted by Bundesbank and/or independent by researchers
  - Recommendation requests legal basis for data collection

Assessing the effects of macroprudential policies: The International Banking Research Network

- **The IBRN brings together researchers from 25 central banks as well as international organizations (BIS, ECB, IMF) to analyze issues pertaining to international banking.**
- **Teams use micro-data to perform rigourous empirical studies, which can be compared across countries.**
- **The 2015-initiative investigates the impact of (macro-)prudential policies on cross-border banking lending. Key findings:**
  - Capital requirements, loan-to-value caps, and reserve requirements do spill over internationally through banks.
  - Affiliates of foreign banks most important for policy spillovers. Less evidence of inward transmission via home-country global banks.
  - Banks’ responses to regulatory changes are heterogeneous, and accounting for these differences increases significance.

Summing Up

- **Macroprudential policy – like monetary policy – requires a well-defined policy cycle, including impact assessments.**
- **Policy evaluation requires legal mandates and availability of sufficiently granular data.**
- **Balancing international and national responsibilities is crucial:**
  - International standards versus national discretion
  - Notification and reciprocity
  - Standards for policy evaluation
  - Ensuring data availability and access