Panel 6: New macroprudential instruments for managing new risks

Macroprudential policy in Europe and France[1]

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[1] Opinions expressed are those of the author only and do not necessarily reflect the views of the Banque de France or the Eurosystem.

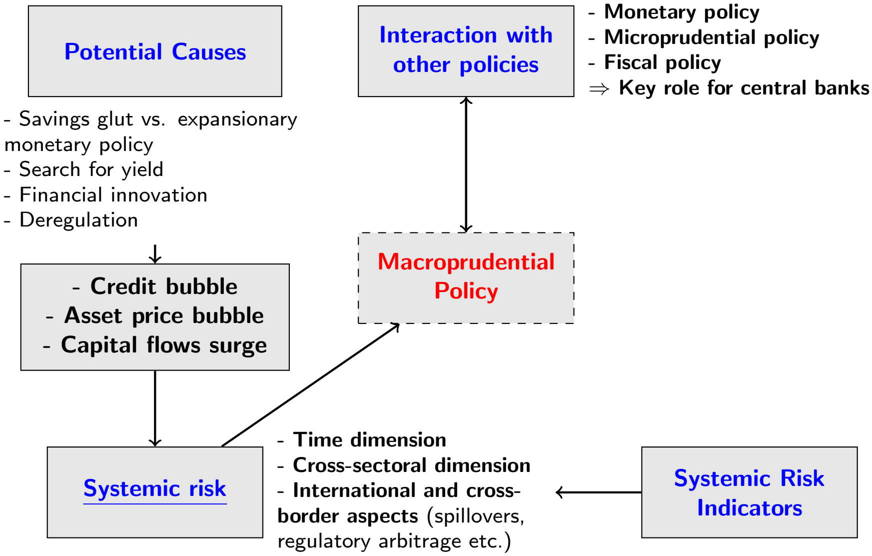
Outline

- Introduction
- The European macroprudential policy framework
- The French macroprudential policy framework
- Managing new risks
- Conclusions / Discussion

The overall picture

- **"Macroprudential policy aims at "limiting systemic risk", i.e. the risk of widespread disruptions to the provision of financial services that have serious consequences for the real economy"** (CGFS, 2014).
- Macroprudential instruments help in reaching macroprudential policy objectives.
- The "four" intermediate objectives of macroprudential policy:
  - reduce moral hazard in the banking sector and increase the capacity of the financial system to absorb losses if a risk materializes;
  - prevent excessive maturity mismatch (liquidity shocks);
  - limit exposure concentration and the resulting contagion phenomena;
  - limit excessive credit risk and leverage.

Overview of the macroprudential policy framework



Overview of the macroprudential policy framework (2)

Objective
-limit systemic risk

- strenghthen financial system resilience
- lean against the financial cycle

Macroprudential Policy

Scope

- **Banking system**
- **Shadow banking system**: MMFs, repos, hedge funds, securitisation
- **Financial market utilities**

Instruments

- **Time dimension**: countercyclical capital buffer (CCyB), sectoral capital requirements, time-varying LTVs, DSTIs, LTI caps, liquidity-based instruments
- **Cross-sectoral dimension**: systemic risk buffer (SRB), capital surcharges for SIFIs

Governance

- **France (French banking and financial stability law)**: HCSF, Banque de France role in the HCSF
- **Europe** (CRD IV, CRR, ESRB regulation and recommendations, SSM regulation)
- **International (Basel III, G20 decisions, FSB guidance)**

⇒ **Importance of (i) decision-making power at national level as well as (ii) international consistency**

Macroprudential policy steps

1. **Risk identification and assessment**: set of indicators, risk assessment, stress tests to assess build-up of risks relative to intermediate objective(s); threshold to signal need for action.
2. **Instrument selection and calibration**: select instrument(s) according to underlying source of risk and intermediate objective(s), effectiveness and efficiency; consider possible cross-border spillovers and unintended effects; calibrate: stress tests may be useful.
3. **Policy implementation**: "guided discretion", avoid inaction bias; communication; interaction with other policies.
4. **Policy evaluation**: feedback on effectiveness and efficiency.

What is a macroprudential instrument?

- **Tinbergen rule** ("for each policy objective, at least one policy instrument is needed").
- **Macroprudential instruments** are characterized by their:
  - **nature** (explicitely developped for macroprudential policies; recalibrated "micro" instruments adapted for financial stability purposes; existing tools; capital-based, liquidity-based, asset-side instruments) ;
  - **scope** (target; sector; indirect effects; cross-section versus cycle dimension);
  - **legal basis** (legal base; institution that implement them; validation/agreement/recognition of their activation).
- What is available? $\Rightarrow$ CRD IV, CRR, national law (optional)

Main macroprudential policy instruments in CRD IV

Legal text	Article	Instruments	Authority in charge
CRD IV	130 and 135 to 140	CCyB	Designated authority In France: HCSF
	131	G-SII surcharge O-SII surcharge	Designated or competent authority In France: ACPR
	133 and 134	SRB	Designated or competent authority In France: HCSF
	103 and 105	Pillar 2	Competent authority In France: ACPR
	129	Exemptions from the capital conservation buffer	Designated or competent authority In France: ACPR

Notes: CRD IV- Capital requirements directive IV; HCSF- Haut Conseil de Stabilité Financière; ACPR- Autorité de Contrôle Prudéntiel et de Résolution; CCyB- countercyclical capital buffer; G-SII- global systemically important institutions: O-SII- other systemically important institutions; SRB- systemic risk buffer.

Main macroprudential policy instruments in CRR

Legal text	Article	Instruments	Authority in charge
CRR	458	"Flexibility package": possibility to impose stricter requirements at the national level regarding own funds, large exposures, public disclosure, liquidity, risk weights for the property sector, or intra financial sector exposures	Designated or competent authority In France: HCSF
	124	Higher real estate risk weights	Competent authority In France: ACPR
	164	Higher minimum exposure - weighted average LGDs	Competent authority In France: ACPR

Notes: CCR - Capital requirements regulation; LGDs - loss given default.

Main macroprudential policy instruments in national law (optional)

Legal text	Instruments	Authority in charge
Optional: National law	LTV cap or stricter lending criteria	Designated authority In France: HCSF
	LTI / DSTI cap	Designated authority In France: HCSF
	Liquidity instruments (e.g. LTD limit)	In France: NA
	Leverage ratio (macropru)	In France: NA

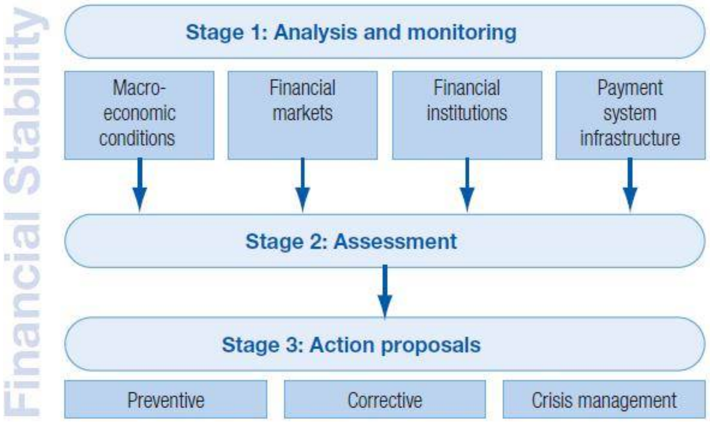
Notes: LTV - loan to value; LTI - loan to income; DSTI - debt service to income; LTD - loan to deposit.

Macroprudential instruments - How to choose?

- **Report of the CGFS study group on experiences with the ex ante appraisal[2] of macroprudential instruments (2016)**, chaired by Anne Le Lorier (Bank of France)
  - often policy has to devise new analytical methodologies and explore (or create) novel data sources to conduct appraisals $\Rightarrow$ **no single preferred approach has (yet) emerged**;
  - **macroprudential policymaking relies increasingly on quantitative analysis, but this does not obviate the reliance on judgment**;
  - **governance arrangements should promote wider cooperation in conducting appraisals** because these exercises require a diverse set of skills and depend on the setting of other policies.

[2] Appraisal refers to the quantitative analysis of how the deployment of an instrument may help achieve financial stability objectives and how this benefit balances against any adverse economic and financial side effects.

Macroprudential instruments - How to activate?



The French macroprudential policy framework - legal setting

- **Law on the separation of banking activities** (voted the 26th of July 2013):
  - Banque de France (BdF) - an explicit mandate in the field of financial stability;
  - **High Council for Financial Stability** (Haut Conseil de Stabilité Financière, HCSF) set up (see HCSF mandate in Appendix 1).

The French macroprudential policy framework - main actors

Institutions having their own mandate	
Banque de France	Central bank with explicit mandate for financial stability
ACPR	Supervisor for banks and insurance companies / resolution
AMF	Financial markets authority
Ministry of Finance	
ANC	Accounting rules authority
Transversal institution	
HCSF	New institution (set up in July 2013) 8 members: Minister of Finance, Governor of BdF, Secretary General of the ACPR, President of AMF, President of ANC, 3 qualified persons. At least 4 meetings a year.

Notes: ACPR - Autorité de Contrôle Prudéntiel et de Résolution; AMF - Autorité des Marchés Financiers; ANC - Autorité des normes comptables; HCSF - Haut Conseil de Stabilité Financière.

Managing new risk - the French commercial real estate market*

***The Report of the CGFS study group on macroprudential policy objective-setting and communication (forthcoming)**

The risk assessment of the French CRE market:

- **Buoyant market**:
  - Strong demand and persistent investors appetite: high volumes of transactions in 2014-2015, foreign investors;
  - Low interest rate environment $\Rightarrow$ search for yield;
  - High commercial real estate (CRE) prices;
  - Heterogeneity of market segments: larger increase of transaction volumes and/or prices in certain sub-sectors (e.g. Paris offices sector).
- **Reassuring (+)**:
  - Investors seem to target "quality assets" (i.e. CRE assets as safe haven);
  - No overheating observed in the construction sector.

Risk assessment of the French CRE market

- **Less reassuring (-)**:
  - Pronounced increase in CRE prices since 2010, larger than in neighbour countries (Germany, Spain, Italy, Belgium);
  - Erosion of profitability (rental yields) since 2000, now the weakest among the main EA neighbours (BE, DE, ES, IT).
- **Price overvaluation**:
  - 15-20% range according to our estimates;
  - Close to 30% for certain segments such as offices in Paris (in particular QCA).
- **Offices sector' vacancy rates**:
  - High in the whole Paris area, less in Paris QCA;
  - May indicate mismatch between demand and supply in certain areas and/or for certain types of assets.

These elements could trigger a reversal of the current situation (strong demand for CRE assets supported by asset price increases and prospects of capital gain). **Main risk is a downward price correction** $\Rightarrow$ need for an action plan.

Action plan

- **Publication of the HCSF's analysis of the CRE market for consultation (15 April 2016)**
  - Example of communication as an instrument in its own right (or "soft" instrument) to raise market participants' awareness of potential risks.
- **(Possible) Additional macroprudential / supervisory actions**
  - "Soft" instruments (communication);
  - "Intermediate" instruments (recommendations);
  - "Hard" instruments currently at the disposal of the HCSF.
- **Currently available instruments not necessarily well suited to tackle risks in the CRE market**
  - The HCSFs macroprudential toolbox could be expanded, so as to target insurance companies and fund managers (not only banks).

Impact of HCSF's communication

Press coverage following communication:

- "**The HCSF concerned about a 30% overvaluation of offices in Paris**" (*LeRevenu, Boursorama*)
- "**Commercial real estate: the authorities warning to insurance companies**. The French commercial real estate market could be overvalued by 15 to 20% on average. In the case of a turnaround of CRE prices, insurers would be most impacted" (*Les Echos*)
- "**Insurers exposed to Paris real estate** . The HCSF concerned about overvaluation of commercial real estate assets, insurers are particularly exposed" (*L'Agefi*)
- "**A bubble in real estate values could burst in France**. In a recent analysis the HCSF points to the risks in the French commercial real estate market. The authority highlights a situation of "strong demand" and "overvaluation"" (*Le Figaro*)

Impact of HCSF's communication (2)

- **Written reaction to the consultation by stakeholders**
  - Data quality issues (need to control for sample composition effects).
  - Suggestion to consider additional indicators in the analysis (e.g. profitability indicator - latent or expected capital gains) and/or to focus on profitability of Paris vs. London offices.
  - (Few) critics of the assessment per se (e.g. high vacancy rates not alarming).
- **Immediate follow-up**
  - If possible, complete the analysis based on new data.
  - Consider the proposal to set up a coordinating committee between market participants and regulators in order to improve risk monitoring in CRE market.

$\Rightarrow$ Preliminary analysis suggests **communication was effective** in raising market participants' awareness of risks.

Impact of HCSF's communication (3)

- Stakeholders expressed **the need for clear communication by the HCSF on risk assessment and strategy**.
- **Main risk identified is that of turnaround in CRE prices which could affect the resilience of market participants**.
- **The HCSF is currently investigating the level of risk in CRE sector, in close cooperation with the stakeholders** → further action will depend on the outcome: "intermediate" instruments (recommendations) or "hard" instruments (macroprudential options: measures targeting the banking sector, measures targeting borrowers?) (see Appendix 2)

Impact of HCSF's communication (4)

- Basically, in the French CRE sector:
  - high sectoral risk;
  - a large number of non-bank actors;
  - not only credit relationships but also financial products should be targeted.

$\Rightarrow$ **The existing instruments do not tackle all these aspects related to risk.**

Conclusion

The European Commission Consultation on the functionning of the EU macroprudential policy framework (1 August 2016 - 26 October 2016):

- need of **a simplified and transparent framework** to better define the macroprudential stance, the potential actions and communication.
- need to set **a coherent policy framework and facilitate the implementation of macroprudential measures in an effective, efficient and timely manner**.
- **challenging issues**: extending the macroprudential toolkit to include instruments for non-bank financial intermediaries; including new macroprudential instruments in CRR/CRD IV that make nowadays the object of national law, i.e. those related to credit standards (LTV, LTI, DSTI).

Discussion

- **Are the existing macroprudential instruments effective?**
  $\Rightarrow$ **Too early to say...**
- **What are the costs and benefits of macroprudential instruments?** $\Rightarrow$ Initiatives at the SSM level for **operationalizing macoprudential research**
- **Experience with macroprudential instruments is scarce...**
  $\Rightarrow$ **Should we think about conceiving new macroprudential instruments?**
- **What about the current matching between instruments and risk?**

Thank you for your attention !

Appendix 1. Missions of the HCSF

- Surveillance of financial system and definition of macroprudential policy.
- Opinions and recommendations to prevent systemic risk.
- On proposal by the BdF governor, possibility to impose higher own fund requirements to banks (i.e. CCyB).
- On proposal by the BdF governor, possibility to change parameters for granting credit to banks during periods of high credit growth .
- Possibility to adress opinions to European institutions recommending action to prevent financial instability in France.

HCSF's strategy:
www.economie.gouv.fr/files/strategy_hcsf.pdf

Appendix 2. CRE market in France: Macroprudential measures targeting the banking sector

Measure	Authority in charge	Pros	Cons
Art.124 and 164 CRR	ACPR	Targeted measures Mandatory reciprocity	(Very) limited reach: only 1/3 of exposures in France under SA (124 CRR), only retail exposures for 164 CRR
CCyB (136 CRD) or SRB (133 CRD)	HCSF	Mandatory reciprocity for CCyB	Too broad measures, not targeted at CRE risks
Pillar 2 (103 CRD)	SSM (for) SI banks) \ ACPR	Targeted measure	Not specifically defined for CRE risks No reciprocity
Art. 458 CRR	HCSF	Could help limiting risk concentration on CRE or Ile de France offices real estate Increase RWs on CRE	Burdensome procedures Measures of last resort No mandatory reciprocity

Notes: SA- standardized approach; SI- systemically important; RW- risk weight.

CRE market in France: Macroprudential measures targeting borrowers

Measure	Authority in charge	Pros	Cons
Caps on LTV, DSCR/ICR floors	HCSF	Strenghten resilience of banks and borrowers	Would apply only to new credit flows Limit of LTV caps: pro-cyclical; DSCR/ICR floors: sensitive to interest rates Lack of reliable data regarding distributions of LTV/DSCR/ICR

Notes: DSCR- debt service coverage ratio; ICR- interest coverage ratio.

CRE market in France: Macroprudential options (3)

Measure	Authority in charge	Pros	Cons
Measures targeting insurance companies			
Concentration limits	ACPR	Could help limiting insurers' concentration on CRE or subsegments Strenghten insurers' resilience Help targeting not only banks, but also other players	No legal basis, has to be created
Measures targeting fund managers			
Leverage limits (at transaction level and funds' overall leverage)	HCSF? AMF?	Could help limiting funds' leverage when investing in CRE or subsegments Strenghten funds' resilience Help targeting other players	No legal basis, has to be created