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Consultation response

EC Consultation on the Review of the EU Macroprudential Policy Framework

24 October 2016

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on the European Commission's (EC's) consultation on the Review of the EU Macroprudential Policy Framework. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Transparency Register, registration number 65110063986-76.

We summarise below our high-level response to the consultation, which is followed by answers to the individual questions raised.

Overview/Executive Summary

AFME and its members consider that there is a case for individual countries to have a macroprudential authority to take into account regional specificities and systemic risks at local or regional levels. It is essential though to consider further the transnational aspects of macroprudential policymaking and the macroprudential framework under the Banking Union legal arrangements needs to be implemented in a manner which is effective, coherent and symmetrical. This would entail the ability for the ECB to loosen macroprudential requirements where an approach by a national authority would be likely to lead to a wider transnational systemic risk or undermine European growth. The role of the ESRB, relating to the EU as a whole, should be clarified and separate from the ECB and the effective coordination of macroprudential policy should prevent level playing field issues arising and any associated arbitrage.

Macroprudential tools should be comprehensive in their coverage of the sources of macroprudential risk and not limited to the directly regulated community. In the meantime, however, it is not clear that the 'pecking order' set out in the CRR/CRD IV for banks is followed in practice and the potential complexities in seeking to target risk arising from 'real estate' exposures needs to be appreciated.

Questions

Question 1: Do you consider the degree of coordination between the different authorities in the current framework (i.e. ESRB, national macroprudential authorities, Commission, Council, etc.) appropriate?

We consider that there is a case for individual countries to have a macroprudential authority to take into account regional specificities and systemic risks at local or regional levels. We note that the ESRB has issued recommendations on core elements of national macroprudential mandates which include recommendations that central banks should play a leading role, and that there should be appropriate coordination mechanisms with other authorities and a consistent set of policy tools. This will include close coordination with microprudential supervisors, and there might be appropriate structures or groupings of supervisors where regional specificities could be addressed. In all instances microprudential supervision will be targeted on an institution specific basis by competent authorities and will apply prior to the application of any macroprudential tools by a delegated authority. In addition, the consideration and coordination of macroprudential policy with fiscal policy is of high importance.

We believe, however, that given the ever closer integration of the Eurozone economy and the creation of the Banking Union in Europe, as well as the high risks of spillovers and regulatory arbitrage more broadly, it is essential to consider further the transnational aspects of macroprudential policymaking.

As a more general point, macroprudential policy instruments should be clearly identified and their purpose made clear and explicit in the policy framework. At present the system is characterised by a considerable overlap of measures and a lack of clarity concerning the conditions for their utilisation. Potential costs of this are a high uncertainty concerning the implementation of each instrument and the risk of the inefficient and costly duplication.

Macroprudential policies, given that they address systemic risk should not be institution specific. The only exceptions to this would be in relation to identifiable structural characteristics of institutions which lead them to pose higher levels of systemic risk than other institutions.

Question2: (a) Would you consider appropriate to expand the macroprudential framework beyond banking? (b) If deemed appropriate, what kind of systemic risks should be targeted and how?

AFME and its members consider that the macroprudential framework should be comprehensive in its coverage of the sources of macroprudential risk to the financial system and not limited to banking or the regulated community. We believe that it is important that the effectiveness of macroprudential tools is not limited by inadequate coverage of the population of risk posing firms or business activities and that tools can be applied to the relevant risk posing entities and activities. However, by way of clarification, macroprudential tools should be applied to the financial sector only, most specifically to financial institutions including shadow banking entities (e.g. leveraged asset managers) that may give rise to specific risks of contagion.

Cyber-risk is an example of a possible further type of systemic risk that needs to be addressed as it relates to the financial sector in view of its possible implications for the financial system. It should be noted though that not all systemic risks need a macroprudential solution. When considering the use of a macroprudential tool for targeting a systemic risk there would need to be sufficient clarify from regulators that this is the most effective approach.

Question 3: Do you see a need to strengthen the coordination between designated and competent authorities when using stricter Pillar 1 measures for real estate exposures to address systemic risks? If you see a need, how should their coordination be strengthened?

We consider that microprudential supervision should be closely informed by macroprudential circumstances (and vice versa) since macroprudential policy is to a significant extent implemented using microprudential instruments. In this respect close and effective coordination between designated and competent authorities is important as mentioned in our response to question 1. A harmonisation of Pillar 1 measures for real estate exposures to address systemic risk would therefore be desirable to allow sufficient clarity and simplicity around the application of the instruments although we acknowledge that in practice lending and decision making criteria can vary across national boundaries. We have included observations in our response to question 5 concerning some of the possible difficulties in identifying and targeting real estate exposure.

Question 5: Do you consider a CCB for sectoral imbalances (e.g. in the real estate sector) a useful complementary instrument? If yes, how would you see the interaction of this sectoral CCB with the CCB already in place?

The CCB mechanism is complex, particularly for internationally diversified banks as they need to monitor large numbers of countercyclical buffer rates which can change at short notice. In addition, owing to its complexity the CCB is not effective from a cost/benefit perspective and is less likely to work from a sectoral perspective. In addition, as the final bank specific CCB requirement is a weighted average of all of these individual rates, the impact of a change or a sectoral requirement for real estate exposure is unlikely to be effective.

More widely, we consider that capital surcharges may not always be the most appropriate tool for sectoral imbalances, and in the case of real estate we would suggest that demand side measures such as LTV, LTI ratios etc. are likely to be more effective.

We would note in addition that there might also be difficulties in targeting risk arising from real estate activity owing to the diversity it encompasses and associated data limitations. For example, 'real estate' exposure could be included as corporate exposure, and involve both high and low risk lending for residential mortgages, exposures to residential landlords, lending to developers, exposure to commercial property (both direct and indirect) and loans against income producing real-estate. These advances may be extended by different types of lender, which may be intermediated or not, retained or distributed in a loan or bond format and possibly bundled with other non real-estate loans and may not always show up as real estate in returns.

Question 9: Do you see the need to better frame either the focus (targeted risks) or the scope of the SRB (i.e. applicability to the entire stock only or also to subsets of exposures)? If so, please explain your answer.

We can envisage situations in which the flexibility to apply the SRB to subsets of exposures rather than the entire stock might be appropriate. Clarity and consistency in the use of the SRB in this way would be important. We consider that the SRB is intended to capture country specific or sector specific risks.

Question 10: Should the SRB be explicitly defined as either an activity based or an institution specific tool? Please explain your answer.

AFME's members have noted that the SRB has in some instances been used de facto as an extension of the O-SII buffer implying an institution specific application. We consider that the SRB should be explicitly defined as an activity based tool and there should be a clear distinction between the SII buffers that capture institution specific elements and the SRB. The macroprudential review could be used to make the distinction more explicit thereby requiring a clear motivation if supervisors want to apply the SRB, and since it is activity based it should, in principle, have the potential to apply to all market participants.

In addition, the introduction and/or possible increase in the SRB should only follow a sufficient phase in period for which we would suggest an alignment with the one year notice time under the CCB.

Question 13: Do you consider that the capital buffers for systemically important institutions are appropriately calibrated in the current framework?

Globally Systemically Important Institutions (G-SIIs) are required to hold an additional capital buffer whose aim is to reflect their potential negative externalities on the stability of the financial system. Size is one of the indicators used to identify such institutions and to determine the size of the buffer. However, the measure of size may encompass the aggregation of entities in jurisdictions or regions which are not connected on a macroeconomic basis. This diversification is likely to act as a risk mitigant but this is not considered when evaluating regulatory capital requirements.

Question 17: Do you see a need for developing additional harmonised macro-prudential instruments? If yes, what type of instrument would you deem necessary and why?

We consider that there should be a common methodology for the quantitative assessment of the effects of diversification under Pillar 2. Such techniques are already in place, for instance by rating agencies in their assessments.

Question 19: Do you consider the current hierarchy of instruments ('pecking order') as appropriate?

We note that the consultation states correctly that the current 'pecking order' set out in the CRR/CRD IV provides that instruments in the hands of microprudential supervisors (Articles 124 and 164 CRR, Pillar 2) and macroprudential instruments with less discretion (CCB, G-SII and O-SII buffers) and considered for application first, before more discretionary macroprudential tools (SRB, Article 458 CRR) can be used.

In practice, however, AFME members have noted that it is not clear whether this order is followed or if Pillar 2 instruments were used before imposing macroprudential buffer requirements. The uncertainty is even greater under stressed conditions. In addition, the potential overlap between Pillar 2 requirements and guidance and buffer requirements is sometimes not clear and there could be instances in which buffer requirements are imposed for risks that have already been covered through a Pillar 2 requirement and guidance. An example of uncertainty and possible overlapping is the interaction between Pillar 2 guidance and the capital conservation and countercyclical capital buffers. There are also instances where the potential implications and overlaps of the use of Pillar 1 measures as macroprudential tools need to be coordinated with other measures more broadly. As mentioned earlier in our response, we consider that in all instances

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micropudential supervision will be targeted on an institution specific basis prior to the application of macroprudential tools.

Moreover, these overlaps occur between the capital framework and accounting provisioning standards. For instance, some firms will consider the effect of potential scenarios upon the loss absorption capacities and provisioning. In addition, adverse macroeconomic scenarios are considered in relation to the CCB and also in the context of Pillar 2 requirements. Finally, future provisions under IFRS 9 will consider estimates of losses in a number of different scenarios. If not adequately considered, there is the possibility therefore of not only double, but triple, counting required loss absorption capacities.

More widely, AFME is supportive of the clarifications that are being made to the CRD in the context of the forthcoming CRD/R review to ensure that the Pillar 2 framework and associated supervisory powers, in particular restrictions on distributions, are clarified and consistency applied across Europe. We believe that the European Commission should clarify in the Level 1 text that Pillar 2 requirements can only apply where materials risks are not covered by Pillar 1, and that these additional requirements cannot be used to reverse policy choices adopted in the level 1 text.

Question 25: How do you assess the shared responsibilities of the ECB/SSM and national authorities for macroprudential policy within the Banking Union? In particular, do you think that the current asymmetry of powers conferred upon the ECB/SSM is appropriate?

The SSM Regulation provides the competent or designated authorities of the Member States with the ability to apply requirements for capital buffers and any other measures aimed at addressing systemic or macroprudential risks. In this framework, the ECB must be notified at least ten days before a decision is taken and it can object. The Member State is then required to consider the ECB objection before it proceeds with its own decision. The ECB is also able to apply higher requirements for capital buffers than applied at national level, and more widely apply 'more stringent measures aimed at addressing systemic or macroprudential risk'.

ECB powers in relation to the application of macroprudential tools are, however, asymmetrical in that the ECB can only tighten measures. As mentioned, the ECB can voice its disagreement with a national authority's use of a tool or the extent of its use but this is non-binding. We are of the view that the ECB should have the ability to loosen national macroprudential requirements where their current application would be likely to lead to wider transnational systemic risk or undermine European growth.

We would note also that the ECB is limited to the use of macroprudential tools set out under the CRR and we are of the view that it should be able to apply a wider set of tools, including demand side tools such as LTV and DSTI limits. This would allow the ECB to provide more sufficient challenge to national authorities, in particular where risks might arise to European growth and in relation to level playing fields.

As mentioned earlier, we do, however, consider that there is a clear case for individual countries to have a macroprudential authority, particularly owing to the degree of national or regional flexibility that is necessary owing to differing stages of cycles in different jurisdictions and the extent of the knowledge of local specificities that might be needed.

More widely, we have mentioned cyber-risk posed to financial institutions earlier as a possible source of systemic risk and we consider that a common IT cyber-risk framework would be useful for supervisors and

relevant firms. Sharing information about attempted or actual cyber-incidents is very important and the creation of an international mechanism for incident notification might contribute to cyber-stability and allow supervisors to identify evolving vulnerabilities. We note that the ECB launched a pilot on the classification and reporting of cyber-incidents with the creation of a cyber-attack system in May which should serve as a basis for the consideration of cyber-risk.

Question 29: Do you think that the ESRB's mandate and tasks are appropriately formulated to ensure efficient coordination of macroprudential policies in the EU? If not deemed fully appropriate, what changes would you suggest to ensure such efficient coordination?

Consideration needs to be given to how the approach to Banking Union macroprudential oversight relates to the ESRB and its role with non-SSM countries, as well as in relation to non-banking financial sector firms and non-bank systemic risk arising from shadow banking activity. We consider that there should be greater clarity about, and separation and coordination of, the respective macroprudential roles of the ECB and ESRB. The ECB, together with national authorities, should clearly be responsible for the implementation of macroprudential policy within the Banking Union zone. In the meantime, the ESRB should be responsible for monitoring macroprudential risks across the EU as a whole, developing strong analysis, and making comply-or-explain recommendations to national, zonal or regional authorities.

The ESRB should have greater visibility than at present, enabling it to play a leading role in the oversight of macroprudential policy across Europe, ensuring its consistency of application and cross-border coordination. Its governance, mandate and structure need to reflect this role across SSM and non-SSM countries, working in close cooperation with the ECB and other central banks and supervisory authorities in Europe.

Question 35: Would you consider the two-tier managerial structure along the lines proposed above an appropriate way to improve the governance structure of the ESRB?

AFME would consider the two-tier managerial structure proposed a possible option towards strengthening and simplifying the governance of the ESRB, in addition to enhancing the role of the Steering Committee.

Further Observations

We note the EC's statement on page 22 of the consultation on the merits of a minimum leverage ratio and that from a macroprudential perspective it might be useful to monitor the risk of excessive bank leverage at a system level. AFME is supportive of the introduction of the leverage ratio in the European prudential framework as a simple, transparent and non-risk-based backstop to the risk based requirements and in a manner which is as consistent as possible with the BCBS' agreed leverage framework.

A stated purpose of the leverage ratio is to avoid contributing to the cycles of 'fire sales' of certain types of assets during periods of market stress. Clearly, cash does not fall into this category. In this context, we note that on 5 July the Bank of England's Financial Policy Committee published the conclusions of its review of its leverage ratio framework in its Financial Stability Report1 expressed strong concerns regarding the inclusion of central bank cash balances in the leverage ratio, noting that "there is no direct benefit to funding holdings of reserves with capital" and that their inclusion in the leverage can "affect the ability of the banking system to cushion shocks and to draw on central bank liquidity facilities, as necessary, to maintain the supply of credit and support for market functioning". We share the FPC's concerns. Similarly, cash and high quality government

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bonds are used as collateral by most market participants for central clearing and other financing transactions and as liquidity reserves by small and large banks, investment funds and corporates. They play a critical role in the smooth functioning of financial markets. If market participants' ability to generate liquidity through these assets is impaired due to constraints on bank balance sheet capacity, particularly during stress periods, it will have ramifications for the functioning of financial markets.

AFME contacts

Mark Bearman, mark.bearman@afme.eu +44 (0)20 3828 2675