



EUROSÜSTEEM

# MACROPRUDENTIAL POLICY FRAMEWORK

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## 1. THE STARTING POINTS FOR THE MACROPRUDENTIAL POLICY FRAMEWORK

Changes to the Eesti Pank Act came into force on 19 May 2014 giving the central bank a clearer mandate than before to act as a macroprudential authority in Estonia. Under Section 2(2) of the Eesti Pank Act, the duties of Eesti Pank include supporting the stability of the financial system and conducting macroprudential policy.

In Section 24<sup>1</sup> of the Eesti Pank Act, the bank's responsibilities in macroprudential supervision are:

- 1) to collect information that is needed for the exercise of macroprudential supervision;
- 2) to ascertain the participants and the financial structures whose actions may exert a significant influence on the formation of systemic risks;
- 3) to identify systemic risks and assess their significance;
- 4) to draw up and disseminate overviews and assessments concerning the stability of the financial system and risks in the system;
- 5) to cooperate with the Ministry of Finance and the Financial Supervision Authority in so far as is necessary for the exercise of macroprudential supervision;
- 6) to implement measures to reduce systemic risks as provided for in legislation;
- 7) to perform other acts that are necessary for achieving the aim of macroprudential policy.

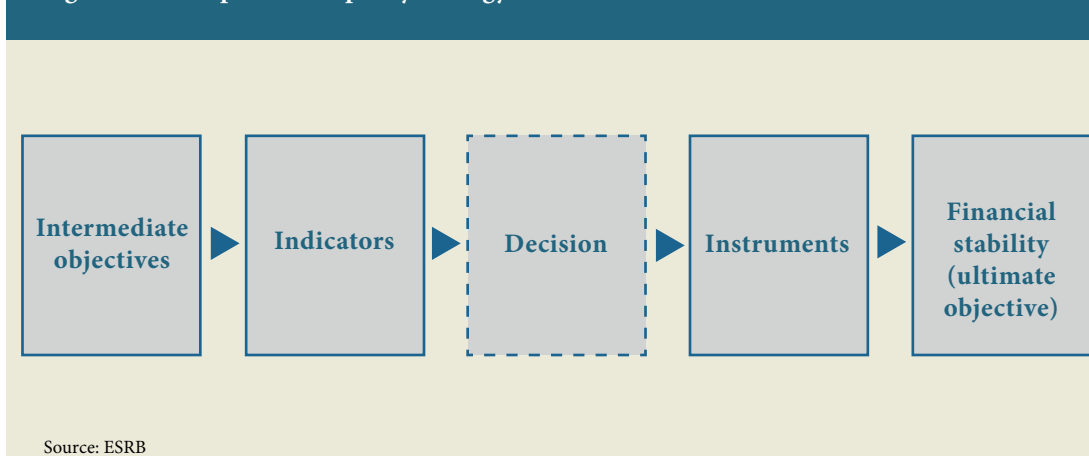
This framework describes the principles, duties and cooperation behind Eesti Pank's work in macroprudential policy. The framework is based on the acquis of the European Union and the agreed principles of the European Systemic Risk Board (ESRB)<sup>1</sup>.

For the sake of clarity and transparency in the decisions on macroprudential policy, intermediate objectives have been set in the framework together with the ultimate objective. These intermediate objectives are then associated with macroprudential instruments and with indicators of sources of systemic risk (see Figure 1).

As a macroprudential authority, Eesti Pank regularly analyses the functioning of the financial sector and assesses the threats to it, and where necessary it takes measures to reduce systemic risks.

Cooperation in macroprudential supervision starts from a division of work between the local institutions responsible for financial stability and the organisation of macroprudential supervision at European Union level.

Figure 1. Macroprudential policy strategy



Source: ESRB

<sup>1</sup> ESRB recommendation ESRB/2013/1

## 2. DEFINITIONS

### Macroprudential policy

Macroprudential policy covers systemic risk analysis and assessment and the deployment of measures to help ensure support financial stability.

### Financial stability

Financial stability means the smooth functioning of financial intermediation under both normal and unexpectedly adverse circumstances. Financial stability is a necessary precondition for a financial system to be able to provide credit and support sustainable economic growth.

### Systemic risk

Systemic risk is a risk of disruption in the financial system with the potential to have serious negative consequences for the functioning of the financial system and the real economy<sup>2</sup>. There are two dimensions of systemic risk, cyclical and structural. The cyclical dimension of systemic risk stems from the tendency of financial institutions to take excessive risks in times of economic growth and to become overly risk adverse during economic downturns. Structural systemic risk comes from the distribution of risk in the financial system; it occurs where financial institutions are so big or so interconnected that if there is an unexpected adverse economic or financial development, they may threaten the stability of the entire financial system.

## 3. THE ULTIMATE AND INTERMEDIATE OBJECTIVES OF MACROPRUDENTIAL POLICY

The financial system has several important roles in the economy, such as converting savings into investments, allowing payments to be made, and managing risks. Any failure of the financial system to carry out those functions will result in very large costs. Because of this, the **ultimate objective** of macroprudential policy is to help ensure the stability of the whole financial system. This then ensures that the contribution of the financial system to the

growth of the economy is sustainable<sup>3</sup>. Macroprudential measures help in achieving this goal by increasing the resilience of the financial system and reducing the build up of systemic risks to financial stability.

As there may be various forms of systemic risk, the macroprudential framework has **intermediate objectives**, which Eesti Pank has set with consideration of the ESRB recommendation ESRB/2013/1 and the specific features of the Estonian financial system. These objectives are:

- to mitigate and prevent excessive credit growth and leverage
- to mitigate and prevent liquidity risk and funding risk in the financial system
- to limit the direct and indirect exposure concentration
- to limit excessive risk-taking by systemically important institutions
- to ensure the resilience of the financial infrastructure
- to ensure the resilience of the banking sector

## 4. THE DECISION-MAKING PROCESS AND ORGANISATION OF MACROPRUDENTIAL POLICY

Eesti Pank follows three closely connected stages when conducting macroprudential policy:

- 1) risk identification and assessment,
- 2) selection and calibration of instruments,
- 3) policy implementation.

### 4.1. Risk identification and assessment

To identify the risks to the stability of the Estonian financial system, Eesti Pank regularly analyses and forecasts the functioning of the financial system. As the Estonian financial system is mainly centred on the banks, the main emphasis of the analysis is on the banking sector. The analysis allows the main systemic risks to the Estonian financial system to be identified and assessed with support

<sup>3</sup> The aim of macroprudential supervision is set out in Section 24<sup>1</sup> (1) of the Eesti Pank Act: "The purpose of macroprudential supervision is to promote the stability of the financial system as a whole by enhancing the resistance of the system to shocks and by reducing the accumulation of systemic risks, and thereby to ensure the sustainability of the contribution of the financial sector to economic growth."

<sup>2</sup> Article 3 (10) of Directive 2013/36/EU of the European Parliament and of the Council

from the stress tests and expert judgements. The results and assessments from the analysis are published twice a year by Eesti Pank in the Financial Stability Review, and more frequently in exceptional circumstances.

Eesti Pank monitors the development of systemic risks using indicators that help in assessment of the build-up of sources of risk and the need for macroprudential measures to be taken. The list of risk indicators associated with the intermediate objectives is only indicative and can be extended to match the development of the financial system and macroprudential policy (see Table 1).

#### 4.2. Instrument selection

The macroprudential tools available to Eesti Pank can be divided into three groups:

1) Moral suasion measures, with which Eesti Pank can draw the attention of market participants to

vulnerabilities in the financial system and so influence their decisions indirectly. This can include advice to market participants, but also covers the analysis and risk assessments in the Financial Stability Review, public presentations and press releases. Eesti Pank can also give its opinions and recommendations on measures that fall within the remit of other institutions.

2) Instruments set out in the European Union's Capital Requirements Regulation and Directive (CRR/CRD IV), where the principles for implementation and coordination have been harmonised in the European Union. These include capital buffer requirements such as countercyclical capital buffers, systemic risk buffers, and systemically important institution buffers, and also adjustments to the risk weights used in calculating the capital requirements.

3) Requirements for issuing loans, which derive their legal basis from the Credit Institutions Act.

**Table 1. Indicators for intermediate objectives**

Intermediate objective	Indicators
<b>To mitigate and prevent excessive credit growth and leverage</b>	Annual growth in loan volumes, credit-to-GDP ratio and gap, real-estate market developments, leverage of banks, capital adequacy, and others
<b>To mitigate and prevent liquidity risk and funding risk in the financial system</b>	Loan-to-deposit ratio, structure of liabilities and distribution of maturities, structure of liquid assets and share in total assets, liquidity coverage ratio, stable net funding ratio, market funding risk ratio, and others
<b>To limit the direct and indirect exposure concentration</b>	Concentration of exposures to individual sectors, countries, maturities and currencies
<b>To limit excessive risk-taking by systemically important institutions</b>	Ratio of banking assets to GDP, volume of deposits, volume of assets, claims and liabilities to other financial institutions, and others
<b>To ensure the resilience of the financial infrastructure</b>	Indicators of the resilience of financial infrastructure to credit, liquidity and operating risk
<b>To ensure the resilience of the banking sector</b>	Indicators showing the vulnerability of the economy and the financial sector

Eesti Pank has the right to set limits on the loan-to-value ratio, the loan-to-income ratio, the debt service-to-income ratio and the maximum maturity of loans, and on the loan-to-deposit ratio of credit institutions<sup>4</sup>.

The most appropriate macroprudential instrument is chosen for each separate intermediate objective (see Table 2).

The starting point for Eesti Pank in applying such instruments is that the selection and calibration of the instrument should reflect the distribution of risks within the financial system, the financial cycle, and sources of imbalance. The principles used in this selection and calibration are:

- **Effectiveness.** The measure has to be effective in reducing market failures and in achieving macroprudential objectives.
- **Efficiency.** The objectives should be achieved at the lowest possible cost and with minimal side-effects.
- **Proportionality.** The obligations associated with the measure should be in line with the contribution to systemic risk.
- **Clarity and transparency.** The nature, goal and adoption of the measure must be clear and comprehensible.
- **Specifics of the Estonian financial system.** Macroprudential measures are guided by the rules in the European Union's Capital Requirements Regulation and Directive and the recommendations of the ESRB. Within this,

**Table 2. Instruments available for achieving intermediate objectives**

Intermediate objective	Instrument
<b>To mitigate and prevent excessive credit growth and financial leverage</b>	Countercyclical capital buffer* Limit on the loan-to-value ratio* Limit on the loan-to-income ratio* Limit on the debt service-to-income ratio* Maximum maturity for loans* Macroprudential leverage ratio Risk weights for real-estate loans**
<b>To mitigate and prevent liquidity risk and funding risk in the financial system</b>	Macroprudential adjustment to the liquidity coverage ratio** Macroprudential adjustment to the net stable funding ratio** Limit on the loan-to-deposit ratio*
<b>To limit the direct and indirect exposure concentration</b>	Large exposure restrictions**
<b>To limit excessive risk-taking by systemically important institutions</b>	Capital buffer for systemically important credit institutions*
<b>To ensure the resilience of the financial infrastructure</b>	Recommendations to the overseer of payment and settlement systems
<b>To ensure the resilience of the banking sector</b>	Systemic risk buffer*

\* Within the direct remit of Eesti Pank

\*\* Can be applied by Eesti Pank in cooperation with the European Commission and the Council of the European Union (measures under Article 458 of Regulation (EU) No 575/2013)

<sup>4</sup> § 83 section 2<sup>1</sup> of the Credit Institutions Act

account is taken of the structure of the Estonian financial sector and measures are adapted to suit the local macro-financial environment and structure and legal background.

### 4.3. Cooperation

Macroprudential policy is closely linked with other policy areas, above all microprudential supervision, monetary policy and fiscal policy, and it may also have cross-border implications. This indicates that the macroprudential tools available to Eesti Pank are not enough alone for achieving the ultimate goal of financial stability, while at the same time, macroprudential measures may be taken to correct the effect of imbalances that have arisen from other policies. This means that effective macroprudential policy needs to be built on good cooperation and reliable coordination mechanisms.

#### *Domestic cooperation*

At the local level, Eesti Pank works closely with the Financial Supervision Authority and the Ministry of Finance. Meetings of the joint committee of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance discuss assessments of financial stability and risks to it at least twice a year along with other aspects of Estonian financial sector policy, and planned macroprudential measures. All the partners can give an opinion on the measures before they are finally confirmed.

#### *International cooperation*

There are three main directions to international cooperation at Eesti Pank:

##### **1) Work with the European Central Bank**

Eesti Pank shares responsibility in the Single Supervisory Mechanism with the European Central Bank in macroprudential supervision<sup>5</sup>. The Capital Requirements Regulation and Directive (CRR/CRD IV) allow the European Central Bank to set even stricter requirements than those that Eesti Pank has passed if necessary. Shared responsibility means that within the single supervision mechanism, Eesti Pank and the European Central Bank have to notify each other of any macropru-

dential measures before introducing them, and they must duly consider each other's opinion when deciding on the measures.

##### **2) Work with the European Systemic Risk Board (ESRB)**

The ESRB is responsible for macroprudential policy at the European Union level; it assesses the threats to financial stability in the European Union and makes recommendations and gives warnings if needed about reducing risks or the impact of them being realised. This means that Eesti Pank can base the formation and adoption of its macroprudential policy decisions on its own initiative or proposals from the European Central Bank, or on the recommendations and warnings of the ESRB. Eesti Pank informs the ESRB of the introduction of new measures under the terms of the Directive 2013/36/EU (CRD IV) of the European Parliament and of the Council.

##### **3) Nordic-Baltic cooperation**

As one of the main defining features of the Estonian banking sector is its strong links with the Nordic countries, Eesti Pank works to safeguard financial stability with the central banks of the region, and with other authorities responsible for financial stability. Macroprudential cooperation takes place in the informal high-level Nordic-Baltic Macroprudential Forum (NBMF). Close cooperation in the Nordic and Baltic area is also important because the home countries of the parent banks of several banks operating in Estonia have not joined the single supervision mechanism. It should also be remembered in this cooperation that in several cases the central bank is not defined as a macroprudential authority of that country.

### 4.4. Communication

The main goal of public communication of Eesti Pank's macroprudential policy is to help ensure financial stability by shaping the expectations of market participants, improving market discipline and informing the public of the bank's work. In order to achieve this, macroprudential policy communications at Eesti Pank covers

- accountability
- macroprudential supervision decisions and explanations of their reasoning

<sup>5</sup> The tasks and tools for macroprudential supervision of the European Central Bank are set out in Article 5 of European Union Council regulation (EU) No 1024/2013.

- public information to raise awareness and warn of systemic risks if publishing such information does not in itself create risks for the stability of the financial system.

In its content, macroprudential communication can be divided into three closely interconnected parts:

- 1) the nature and institutional framework of macroprudential policy,
- 2) assessment of systemic risks,
- 3) macroprudential tools and measures.

Table 3 shows the main topics that Eesti Pank covers in its public communications on macroprudential policy.

Eesti Pank regularly covers its work related to macroprudential policy in its annual report and the Governor of Eesti Pank presents the annual report to the Riigikogu and responds to interpellations from members of the Riigikogu.

Eesti Pank publishes macroprudential decisions through various channels to ensure that there is enough information and that it reaches the public in a timely fashion. Macroprudential assessments are generally presented twice a year in the press conferences for the Financial Stability Review, and both measures already passed and planned measures are discussed and explained together with the risk assessments.

The central platform for public relations at Eesti Pank is the website, where information about macroprudential measures and the institutional

framework, and risk assessments are published. Alongside its website and social media, Eesti Pank also uses direct communication for its macroprudential messages by holding public lectures, making presentations in seminars and conferences, and answering enquiries.

Public communication by Eesti Pank about macroprudential supervision is based on three principles:

- **Credibility.** Credibility is a key part of public communication as it makes macroprudential supervision more effective and helps in achieving its goals. Considered, coherent and open communication is the base for credibility.
- **Openness.** Openness needs honest and thorough communication based on the best information available. Eesti Pank explains the reasons behind its macroprudential decisions as thoroughly as possible. Eesti Pank communicates actively with financial market participants and other interested parties so as to make sure that risk assessments are accurate and the measures taken are effective.
- **Comprehensibility.** The macroprudential messages from Eesti Pank are well argued and clear so as to lessen uncertainty for market participants. This in turn helps in shaping expectations and in achieving the goals of macroprudential policy.

**Table 3. Public communication on macroprudential policy**

The nature and organisation of macroprudential policy	Assessment of systemic risks	Macroprudential measures
Mandate	Identified risks and assessment of their importance	The nature of each measure
Objectives	Indicators	The level and need for each measure
Decision-making process		Scope of application
Available instruments		Date of entry into force

Source: Based on ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector. March 2014.