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Central Bank of Ireland
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"Birth, growth and towards maturity: macroprudential policy in Ireland" - Remarks by Governor Gabriel Makhlouf at the ESRI

08 November 2021 Speech

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Good morning. It is a pleasure to be here today.

Macroeconomic stability is one of the necessary foundations of a successful economy, necessary to promote the wellbeing of communities. As many of you know, macroprudential policy – both in Ireland and internationally – is a relatively 'young' discipline, at least in its most recent incarnation as it emerged after the global financial crisis. And, while macroprudential policy, like monetary policy, is a key an element of the overall policy framework to achieve broad macroeconomic stability, it remains much less understood.

That is hardly surprising. Unlike monetary policy, macroprudential policy does not have an easily observable target. And the panoply of potential macroprudential interventions entails a different degree of complexity, when compared to the set of monetary policy tools currently employed by central banks around the world.

I would like to use today's webinar to explain in more depth our approach to, and plans around, the macroprudential policy framework in Ireland.

I will cover the fundamental rationale for an effective macroprudential policy framework, especially in a small-open economy like Ireland, lessons from our experience to date and our plans to advance and mature the framework in the years to come, as part of the Central Bank's new strategy.[1]

The origins of the (modern) macroprudential policy framework

Let me start with the origins of (the modern version) of macroprudential policy.

The global financial crisis of 2007-08 imposed enormous cost on businesses and households around the world. At the time, the global economy saw the sharpest contraction in economic activity since the Great Depression. Trade flows and cross-border flows of capital collapsed globally and millions of jobs were lost globally.

Of course, the record for the sharpest global recession since the Great Depression has now been broken by the COVID-19 pandemic. But the costs of the global financial crisis have also been very persistent. Estimates suggest that – even a decade on – potential output per capita across the OECD was around 3% lower than it might otherwise have been. And, within that aggregate figure, there is significant variation across countries. Among the 19 OECD countries that experienced a banking crisis a decade ago, the median loss in potential output per capita is estimated to have been around 6%.[2] Sluggish investment was a key channel through which these losses on potential output manifested, with long-lasting capital and productivity shortfalls relative to pre-financial crisis trends.[3]

The roots of the global financial crisis lay in the build-up of macro-financial imbalances in the preceding period. In the run-up to the 2007-08 financial crisis, credit and assets prices grew rapidly across the world. Lending standards by parts of the global financial sector became excessively loose and borrowers found themselves with unsustainable levels of debt. Leverage of financial institutions themselves had expanded, as did maturity transformation across the financial system. The structure of the global financial sector had become increasingly complex, and increasingly fragile. The global financial sector's balance sheet, and its measured share of overall economic activity, had increased dramatically.[4]

Many of these aggregate trends were visible in the early 2000s, but the global policy framework to achieve macroeconomic stability prior to the global financial crisis was not well equipped to deal with the build-up of risks. At a macro level, central banks focused on achieving price stability through the setting of monetary policy. Indeed, in most mainstream macro-economic models used by central banks at the time, the financial sector did not feature as a possible source – or amplifier – of macroeconomic shocks. At a micro level, regulators focused on the safety and soundness of individual institutions, through supervision of regulated entities. The lens through which supervision approached its mandate did not take into account developments in the financial system as a whole nor, indeed, how the collective behaviour of the financial system could become a source of problems for the economy. Put very simply, in the decades prior to the global financial crisis, there was too great a gap between macroeconomic policy on the one hand and the regulation and supervision of individual financial institutions on the other.

The global financial crisis led to widespread reforms in the global financial system. From higher levels of capital and liquidity for global banks, to the introduction of resolution regimes for failing financial institutions, to a more intrusive approach to supervision.

But one of the key ingredients of the post-crisis reforms involved the birth of a new policy framework altogether: macroprudential policy. This entailed a shift in thinking, by filling the space between finance and the broader economy. Macroprudential policy focuses explicitly on risks to the provision of services to household and businesses by the financial system, not on risks to individual financial institutions in and of themselves. It considers the resilience of the financial system as whole, not just each individual node in the system. And it focuses explicitly on the interaction between finance and the macroeconomy, seeking to avoid adverse feedback loops between the two, such as damaging credit supply contractions or asset fire-sales.

The role of macroprudential policy in Ireland

The development of the macroprudential policy framework in Ireland mirrors this evolution of thinking at the global level. But the nature of the Irish economy – a small, highly globalised economy within a monetary union – creates both unique considerations for the operation of the macroprudential framework and also underscores the importance of such a policy lever from an overall macro-stabilisation perspective.

The Irish economy is one of the most open economies in the world for trade and finance.[5] This openness is a core component of the Irish economic model. It has yielded substantial benefits, evident most recently in the strong performance of MNE-dominated exporting sectors, offsetting the impact of the sharp decline in consumption and domestic demand as a result of COVID-19 health restrictions.

Yet the benefits of a small open economy do not come without vulnerabilities and risks. The Irish economy experiences greater pass-through from developments in the global financial cycle, which is one factor explaining the higher volatility of Ireland's economic aggregates relative to other economies. For example, Central Bank research shows a significantly higher response of Ireland compared to large economies such as the US, UK and euro area as a whole to negative global real and financial market shocks.[6]

In addition to this greater sensitivity to cyclical global developments, the Irish economy is also more prone to structural macroeconomic shocks, such as abrupt shifts in international trading and tax arrangements. Again, Central Bank research shows that growth prospects in small countries are more susceptible to negative shocks than larger, more diversified countries.[7]

Finally, being part of a monetary union means that macroprudential policy plays a particularly important role in the overall policy framework to achieve macroeconomic stability. There is the tendency for the financial system to loosen lending standards too much when times are good. In turn, this means that borrowers can end up with too much debt, leaving them over-exposed in the event of adverse shocks. When those shocks do hit, highly-indebted borrowers are more likely to cut consumption or investment, with damaging implications for the entire economy. This channel is likely to be especially virulent for small open economies operating in a monetary union, as monetary policy has limited capacity to respond to local shocks to financial conditions. Moreover, the impact on aggregate demand when adverse shocks hit at a local level will be greater, given the lack of an interest rate adjustment channel to stimulate the economy.[8]

These factors underscore the importance of an effective macroprudential framework in the context of the Irish economy. Put very simply, achieving a given level of macroeconomic resilience in a small open economy that is part of monetary union, requires a more 'activist' approach to macroprudential policy relative to a larger, more diversified economy, with monetary policy levers at its disposal.

The first decade of macroprudential policy

Given the importance of macroprudential policy in a small and open economy, Ireland was proactive in the implementation of the new macroprudential framework as the country emerged from the financial crisis.

In 2014, building on European-wide legislative developments, the Central Bank outlined its overall approach to macroprudential policy, covering – among others – the objectives of macroprudential policy in Ireland and the instruments available to the Central Bank to help achieve these objectives.[9]

Our stated objectives for macroprudential policy are two-fold: first, to safeguard the resilience of the financial system, so that it can better withstand adverse shocks and continue to provide financial services to households and businesses; and second, to guard against the emergence of financial imbalances or vulnerabilities within the financial system.

With this framework in place, the Central Bank began to introduce policies that aimed to build the resilience of the financial system as the recovery from the financial crisis broadened and strengthened. This phase saw the introduction of the mortgage measures and the capital buffer framework. This period also saw the introduction of the Central Bank's Financial Stability Review as the main vehicle through which the Central Bank communicates its judgements regarding the main risks facing the financial system, the resilience of the financial system to those risks and, in that context, the policy actions taken, to safeguard financial stability.

The first macroprudential intervention by the Central Bank was the introduction of the mortgage measures in early 2015. This was in the context of a recovering housing market, following the boom and subsequent painful bust of the previous decade. House prices had quadrupled in the decade before 2007 and then fell for 20 consecutive quarters, halving in value. By 2015, the economy was coming out of the financial crisis and this was a time of emerging imbalances in the housing market, with house prices increasing by around 15 per cent year-on-year nationally and by around 25 per cent in Dublin, generally attributed to supply shortages.

The objectives of the mortgage measures reflect the broader macroprudential policy objectives, applied more specifically to the mortgage and housing markets. The measures aim to strengthen the resilience of lenders and borrowers to adverse shocks and to guard against the risk that house prices and credit evolve with damaging pro-cyclicality. To achieve that, the measures limit the proportion of new lending that can be extended by lenders at high loan-to-value and loan-to income ratios. The previous crisis had illustrated starkly the damage that can occur when loose credit conditions fuel house price growth and over-indebtedness and the mortgage measures were introduced to reduce the risk that such a credit-fuelled house price boom re-emerges in Ireland.

The introduction of the capital buffer framework in Ireland marked the next phase in the development of the macroprudential framework. The first buffer to be introduced was the so-called 'other systemically important institutions', or O-SII, buffer, which became operational across Europe from 2016. The objective of the O-SII framework is to reduce the probability of failure of a systemically important institution, given the potentially greater impact of failure of those institutions. The failure of one of these systemically important institutions would have a greater impact on the financial system and economy than the failure of a non-O-SII. Higher capital requirements for these institutions, in the form of O-SII buffers, therefore aim to reduce their probability of failure. The Central Bank reviews the list of O-SIIs and their associated buffer rates on an annual basis and announces the result of this review as part of the Financial Stability Review.

The countercyclical capital buffer was a further element of the range of measures introduced in the aftermath of the financial crisis, and also became operational across Europe from 2016. This buffer is a time varying capital requirement which aims to promote a sustainable provision of credit to the economy by making the banking system more resilient. By increasing regulatory capital requirements in line with the cyclical systemic risk environment, the CCyB looks to ensure additional capital is in place to absorb losses when risks materialise. In addition, the release of the CCyB during a downturn looks to limit the potential that regulatory capital requirements act as an impediment to the supply of credit to the economy. The Central Bank framework for the CCyB emphasises the importance of introducing a positive buffer sufficiently early in the cycle to effectively promote resilience. Thus, when there is a sustained trajectory in indicators, consistent with emerging cyclical systemic risk over a period of time the Central Bank expects to maintain a positive CCyB rate. In line with this framework, the Central Bank announced a positive CCyB rate of 1 per cent in July 2018.

Overall, until the arrival of the COVID-19 pandemic, the macro-prudential framework was geared towards building resilience. The economic shock stemming from the pandemic marked the first test of the macroprudential framework, both in Ireland and internationally, since its introduction post the financial crisis.

As the implications of this unusual crisis are still being felt across the world, we are still working through some of the lessons learned from the perspective of the macroprudential policy framework. However, it is clear that we arrived in March 2020 with a much more resilient banking system than would have been the case in the absence of our various macroprudential policy measures and the wider reforms to bank capital and liquidity frameworks since the global financial crisis.

Indeed, despite the unprecedented nature of this economic crisis, we did not see the banking system amplifying the economic disruption. Going into this crisis, the Irish banking system had average CET1 ratios (the highest quality of regulatory capital) of 19 per cent. The decision in Ireland to activate the CCyB at 1 per cent in 2018 allowed for rapid release of the buffer in March 2020. This release, along with ECB Banking Supervision announcements on usability of other capital buffers, enabled banks to absorb losses, without a need to curtail lending supply.

Turning to the mortgage measures, when the pandemic hit, Irish borrowers were more resilient and better able to weather the shock. This higher resilience can be thought of as both direct and indirect resilience. Direct resilience can be seen through the lower take up of payment breaks (which were granted on more than €10.8 billion of mortgage debt - 11.5% of overall balance - in the domestic banking system by mid-2020) by borrowers with lower originating loan to income ratios.[10] The indirect resilience relates to the role that the mortgage measures played in the preceding years in stopping credit dynamics from amplifying the price effects of the demand-supply imbalance in the housing market.

In summary, the mortgage and bank capital based measures meant the system, borrowers, lenders were more resilient when faced with the pandemic shock.

Forward-looking priorities for the macroprudential framework

Let me know turn to some of our forward-looking priorities around the development of the macroprudential policy framework in Ireland. Last week, we published the Central Bank's new strategy for the next five years. So it is an opportune time to outline in more depth our plans to advance the macroprudential framework in Ireland, in the broader context of our new strategy.

A key feature of the environment in which we operate and developed our new strategy around is the pace of change. Of course, change in the structure of economies, in the drivers of economic activity and in financial systems is not a new phenomenon. But a striking feature of the first decades of the twenty-first century is the increased pace of change. We are living in a time where people, capital, trade and ideas are increasingly and rapidly interconnected. The pace of change has accelerated and the evidence points to that continuing.

From the perspective of the macroprudential policy framework, this means that it also needs to continue to evolve, so that it remains fit for purpose – not just now, but into the future. In a nutshell, I would describe the macroprudential framework – in Ireland and globally – as still being in its adolescence. What we want to achieve over the next five years is to advance it towards maturity.

Towards maturity

What would advancing the macroprudential framework towards maturity mean in practice? There are four areas in particular where we want to continue making progress over the next few years:

- A key theme of the Bank's new five year strategy is to be more future-focused. In line with this the first area of progress is advancing our approach to evaluating risks and resilience in a forward-looking and systematic manner, to inform the setting of policy. Like many macro-economic policies, macroprudential policy actions operate with a lag. So, to achieve our objectives, we need to be in a position to reach forward-looking judgements around the magnitude of the risks facing the financial system and the resilience of the system to those risks. This is similar to how monetary policy is set with a view to future inflation dynamics, not the current rate of inflation. So a forward-looking approach is critical. That, of course, is not easy. As you know, it is already hard enough for economists to forecast the central case for the economy.[11] Seeking to reach a forward-looking judgement on the magnitude of tail macro-economic risks, and the resilience of the financial system to those tail risk should they materialise, is an order of magnitude harder and will always entail much higher fundamental uncertainty. We have been making progress in this area. Our modelling toolkit has evolved in recent years. For example, we have been developing our analytical capabilities for understanding how financial conditions and the level of financial vulnerabilities contribute to the possibility of future episodes of weak economic growth.[12] And we have been developing our approach to stress-testing banks, borrowers and non-banks.[13] [14] But our analytical toolkit will need to mature further over time.

- Second, further developing our overall macroprudential policy strategy. Macroprudential policy involves a wide set of instruments. Even within bank capital, there are different types of macroprudential capital buffers. There are also interactions between measures aimed at safeguarding lender resilience and those aimed at safeguarding borrower or non-bank resilience. And macroprudential policy interacts with other policies, whether it is monetary, fiscal or supervisory policy. In that context, it is critical that our regular policy decisions operate within an overall strategy for macroprudential policy that is coherent and transparent. This will improve the likelihood that agents in the economy are in a better position to understand and anticipate our reaction function, strengthening the effectiveness of our policies. It will also enhance the ability of others to hold us to account for the policy decisions we make. Again, this is an area that we have been making progress recently. For example, under the auspices of the European Systemic Risk Board, we have been working with colleagues across Europe to develop the concept and measurement of a “macroprudential stance”.[15] Operationalising such a framework is challenging and will take time. But, as our understanding of the transmission mechanism of macroprudential policy deepens, our overall macroprudential strategy will continue to be refined and developed.
- Third, a clear articulation of, and continued progress on the measurement of, the benefits and costs of our policy actions. Like all policies, macroprudential policy actions (or lack thereof) entail both benefits and costs for society. Our job is to balance these appropriately. We are not seeking to achieve stability at all costs. There are particular challenges with both measuring and communicating the benefits and costs in the area of macroprudential policy. The benefits mainly stem from the absence of developments that might otherwise have taken place, whether that is the build-up of macro-financial imbalances, unsustainable levels of borrowing, or insufficient resilience. So these benefits are often less visible on a day-to-day basis and accrue over time. By contrast, the costs of macroprudential policy are more upfront and also visible. They might include lower mortgage transactions than might otherwise have been the case or a somewhat higher cost of credit when times are good, as the “insurance premium” for more resilient finance when times are bad. While we always seek to balance the benefits and costs, we need to continue to develop the way in which we measure and articulate these to the broader public and those that hold us to account.
- Fourth, ensuring our policy framework remains fit for purpose as the financial system and broader economy continue to evolve. No policy framework should ever remain static. For our policies to be effective, we need to review and develop the overall framework in line with evolution of the financial system and the broader economy. One key dimension here – that I will come back to a bit later – is around the changing nature of financial intermediation and the growing role of the non-bank sector, both domestically and globally. Put simply, over the first decade of macroprudential policy, the focus has been on banks. But – looking ahead – this will not to be sufficient, given the growing role of non-bank financial intermediation.

Achieving these outcomes will take time. It took decades, for example, for our monetary policy framework to evolve and mature. But this is a strategic priority for the Central Bank and we are committed to making concrete, measurable progress over the next five years, working with – and learning from – our international partners as well as advances in academic thinking in this area.

Priorities around the macroprudential framework over the next 12 months

Let me now turn to some more nearer-term priorities, to help provide a broad road-map of developments in this area over the course of the next twelve months and how these fit together. We are conducting a review across three pillars of the macroprudential framework: borrowers, banks and non-banks.

- Borrowers – the mortgage measures

It has now been almost seven years since the introduction of the measures. This has prompted us to take stock, and commence an in-depth review of the overall framework for the measures. While the mortgage measures are a permanent feature of the market, the operation and calibration of which we review annually, we deem a review of the overall framework and strategy to be good practice intermittently, particularly as a range of economic and financial factors, both globally and domestically, have evolved since the measures were introduced.

Indeed, much has changed since the measures were introduced. Globally, interest rates have been on a downward path since the measures were introduced. The role of non-bank financial institutions in the housing market has expanded considerably, while housing supply overall has recovered more slowly than perhaps many people expected back in 2015. At the same time, we now have access to better information, partly due to the Central Credit Register, and can learn from the experience both in Ireland but also a number of other countries that have introduced similar measures over the past decade.

A second key theme of the Bank's new Strategy is to be open and engaged. In line with this, the first step in our review of the framework and strategy for the mortgage measures was to listen to the public that these measures serve. Over the course of the summer, we launched a digital survey, inviting members of the Irish public to participate and give their views on the functioning of the measures. To complement this, we hosted listening events during July, where we invited stakeholders from Irish civil society and business to give their views. The online survey has been the single most direct engagement with the public the Central Bank has ever had. It has been a major milestone in our approach to engagement. Over the course of the summer, we received more than 4,000 individuals responded to our survey, which included more than 9,000 responses to the open-ended questions. The insights gathered through the survey have informed the scope of our work, ensuring that we are considering carefully the issues raised by the public that we serve.

The review of the framework for, and strategy around, the mortgage measures will run throughout this year and into 2022. It will run concurrently to our regular annual assessment, which will be published in the November 2021 FSR. The wider framework review will explore the appropriateness of the stated objectives of the measures, the choice of instruments, the framework and strategy used for calibration, the role that external factors play in our calibration decisions, as well as a focus on operational and communications aspects. The next step for the review will be in December, where we intend to publish a consultation paper, informed by the listening events and our own analysis, around the framework for the mortgage measures.

- Banks – macroprudential capital buffers

The second pillar of our work around macroprudential policy framework is around bank capital buffers. Over the past decade, there have been wide-sweeping and rapid reforms to the overall bank capital framework, including the macroprudential toolkit around bank capital, which is now very extensive. Under European legislation, macro-prudential authorities have the power to set a counter-cyclical capital buffer, additional capital buffers for systematically important institutions, additional capital buffers for structural systemic risks as well as various options for adjusting risk weights.

This extensive toolkit entails benefits in terms of allowing macroprudential authorities to target risks in a more nimble manner. But the different tools means that there is an onus on authorities to consider how these interact together: at the end of the day, these are all different forms of bank capital that is there to absorb losses when shocks hit.

In the review, we will assess how the different elements of the macroprudential capital stack are calibrated, how the risks being targeted by each buffer interact, and articulate our views on an evolution of capital through and over the financial cycle. We will further develop our cyclical assessment toolkit by enhancing our stress-testing framework for explicit macroprudential purposes. Finally, we will take account of legislative changes arising from the transposition of the Capital Requirements Directive Five (CRD V) into Irish law, and incorporate emerging lessons, both domestically and at an international level, from the COVID-19 experience, as relevant to our ongoing operation of macroprudential capital buffers.

In completing this review, we seek to have as clear, well-communicated and predictable a strategy as possible around our approach to bank capital from a macroprudential perspective. That will both allow us to explain our judgements better as well as allow the regulated entities themselves to plan ahead. We intend to outline our thinking in this area in 2022.

- Non-banks – the new frontier

The third pillar of the review will consider the market-based finance sector in Ireland, and in particular Irish domiciled investment funds. These have grown considerably, in size and importance, over recent years. For example, certainly relative to the size of the economy but also in absolute terms, Ireland has one of the largest market-based finance sectors in the world.

From a financial stability perspective, a key priority internationally and indeed in the Central Bank, is deepening policymakers' understanding of the potential implications of a disruption in market based finance on economic activity. The lack of a complete and operational macro-prudential toolkit remains a key gap. In that respect, European and international regulatory bodies have recently signalled the need to develop these tools for the sector to increase their resilience and thus mitigate the need in future for central banks to intervene in a crisis.

The exposures of the Irish non-bank sector are largely international in nature. But linkages to the domestic economy here have been growing, especially via exposures to the domestic commercial real estate market (CRE). The growing importance of property funds as investors in the Irish CRE market since the Global Financial Crisis has brought with it many benefits, including the diversification of financing channels for CRE away from domestic investors towards international investors and a reduced reliance on debt financing intermediated by Irish retail banks. This increases risk sharing and reduces domestic interconnectedness. However, an implication of this structural trend is that it increases the sensitivity of the Irish CRE market to global shocks. And that the resilience of this growing form of financial intermediation for the functioning of the overall CRE market matters more now, than it did a decade ago.

Over the coming weeks, we will publish a consultation paper on potential measures to limit leverage and liquidity mismatches in the property fund sector. These have a macroprudential objective. The proposed measures aim to strengthen the resilience of this growing form of financial intermediation, guarding against the risk that financial vulnerabilities in the sector amplify adverse shocks in future times of stress. This in turn will better equip the sector to serve its purpose as a valuable and sustainable source of funding for economic activity. We will proceed cautiously, but with determination, in this area. We recognise that these are new policy interventions, with limited experience of their use. So this underscores the importance of the consultation, where we intend to listen and learn from stakeholders. At the same time, the area of market-based finance is one in which we are determined to progress. The nature of the financial system is changing and if we stand still, it is almost certain that our framework will not be fit for purpose in years to come.

More broadly, given the international nature of the non-bank sector in Ireland, a key priority for the Central Bank is around the development and operationalisation of the macro-prudential framework for non-banks at a global level. This has to be an internationally co-ordinated endeavour. Capital markets are global in nature, and policies will be most effective if regulators co-ordinate. In that context, I am pleased to see the focus of the Financial Stability Board to on addressing weaknesses in certain sectors of non-bank financial intermediation that were brought into sharper focus during the COVID-19 market turmoil. The recently published policy proposals to enhance money market fund resilience is the first in a body of work that aims to address the vulnerabilities identified in the Holistic Review of the March 2020 Market Turmoil. Developing a systemic risk perspective that can better inform the design and use of appropriate policy tools in the area of non-bank financial intermediation is a key global priority that we will support in coming years.

Conclusion

Making a difference for financial stability requires persistence and stamina. Developing new frameworks is a long endeavour, but it is a worthwhile one.

The sector and society in which we operate is changing rapidly and so are the consumers that we serve. To get ahead of this we must become more focused on the future, be more front-footed and more agile. To be future-focused and become more open, we have to transform key aspects of the way that we operate. But it is through monitoring and strengthening our frameworks that we will continue to regulate financial services and markets effectively, while ensuring that the best interests of consumers of financial services are protected.

[1] See here for further detail on our strategy.

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