FINANCIAL STABILITY AT THE NEXUS OF MONETARY AND MACROPRUDENTIAL POLICIES

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The Eurosystem delivered a swift and massive response to the Covid-19 crisis as it sought to maintain favourable financing conditions for the whole economy. This response was aided by the resilience of the financial system, which was strengthened by reforms introduced in the aftermath of the 2008 financial crisis. It was similarly able to draw on an expanded range of flexible and innovative monetary policy instruments.

But a prolonged accommodative monetary policy can lead to adverse effects for financial stability through reduced market discipline, excessive risk-taking encouraged by the moral hazard created during the resolution of past crises, and increased leverage among economic agents. To more effectively prevent the risks of financial instability and safeguard monetary policy transmission channels, we need to go beyond the principle of strictly separating monetary and macroprudential policies and instead adopt a principle of coordination.

However, the macroprudential framework remains an essential line of defence and must also be strengthened in two critical areas: the European framework needs to be bolstered; and non-bank financial institutions need to be included in the framework.

These reforms represent the new frontier that we must cross as we build on progress towards a safer financial system, within Europe and around the world.

The Covid-19 crisis is testing the soundness of the financial system and, by extension, the appropriateness of all the reforms, including macroprudential reforms, adopted following the 2008 financial crisis.

Unlike in 2008, the banking sector has shown itself to be resilient because it is better capitalised, thanks to joint efforts by micro- and macroprudential authorities. Beyond measures to strengthen the capital of French (but also European) banks, which doubled between 2008 and 2020 to reach around 15% of banks' total (weighted) assets, several macroprudential firewalls were also set up before the crisis broke. In France, the Haut Conseil de stabilité financière (HCSF – High Council for Financial Stability) activated countercyclical buffers, placed limits on the exposure of systemically important banks to the most heavily indebted companies and issued recommendations on exercising caution in housing lending.

These measures have been beneficial in managing this latest crisis, with the soundness of the banking system supporting the effectiveness of measures taken by public authorities, governments and central banks to cope with the pandemic and its economic fall-out. The Eurosystem, in particular, quickly mobilised a broad array of instruments to support financing for the real economy, notably through banks (*see Chart 1*). These measures supplemented fiscal measures adopted domestically to support companies and households hit hard by the crisis.

Yet implementing a persistently accommodative monetary policy could have collateral impacts on financial stability, to the point that the build-up of risks for the financial system might interfere with the effective transmission of monetary policy. Because of this threat, when pursuing a given inflation target, monetary policy not only prioritises instruments whose design and implementation make the smallest possible contribution to financial imbalances, but also factors financial stability-related trends into its action.

Elsewhere, while banks are showing resilience, the growing footprint of investment funds in financing the real economy makes it necessary to ensure that these participants are able to avoid procyclical behaviour that might amplify liquidity stress. In this regard, the macroprudential framework, which applies only to banking entities and essentially on a domestic basis, falls short. A macroprudential framework also needs to be developed for non-bank financial intermediaries, with coordination at international level.

In short, macroprudential policy will not be enough if it is isolated from monetary policy (Section 1). Yet it can and must be more effective at European level (Section 2) as well as regarding non-banks (Section 3).

1 Learn all the lessons from interactions between monetary policy and financial stability

The traditional principle: keep monetary policy separate from macroprudential policy

The global financial crisis in 2008 showed that price stability was not a sufficient guarantee of financial stability and highlighted the need for macroprudential policy. After 2008 came a realisation that crises linked to financial activities, and specifically bank activities, can have systemic consequences that may be extremely adverse for the stability of the wider financial system and sufficiently serious to affect the real economy as well. The way the 2008 crisis unfolded, through its impacts on economic activity and hence on consumer prices, underlined the need to ensure the soundness of the financial system, and specifically of the banking system, to safeguard against a repeat of similar turmoil.

The Basel Committee on Banking Supervision (BCBS) took an important step forward in this regard in September 2010 with the Basel III reform of the international regulatory framework, which was approved by G20 leaders at the Seoul summit in November 2010. In addition to strengthening microprudential capital, liquidity and leverage requirements, the BCBS established a two-part macroprudential framework for bank supervision. First, this framework seeks to reduce the magnitude of financial cycles and thereby contain the tendency of the banking system to exacerbate business cycle peaks and troughs through excessive or, conversely, insufficient credit distribution. The flagship tool introduced was the countercyclical capital buffer, which requires banks to increase their regulatory capital during periods of excessive credit growth. Second, the macroprudential framework aims to mitigate the transmission of shocks through the financial system, notably by means of the capital surcharge required for the most systemically important banks.

This macroprudential response was implemented in accordance with the Tinbergen rule, with macroprudential policy responsible for financial stability and monetary policy in charge of price stability. Under this approach, monetary policy is not intended to act to mitigate financial stability risks, such as those associated with movements in asset prices, e.g. equities or house prices. Two main reasons are traditionally given for this separation: i) the difficulty of identifying asset price bubbles in real time; ii) the uncertainties associated with a monetary policy that is required to pursue conflicting goals.

Limits of separation

Yet it is important to re-examine this rule in the current environment of low interest rates and a monetary policy using a wide and flexible range of instruments.

The mandate assigned to euro area monetary policy is unambiguous: the primary objective is price stability. However, the Treaty[1] states that "*The ESCB[2] shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system*". In executing this mandate, the Eurosystem already pays close attention to fairly broad financial aggregates when determining its monetary policy stance. For example, it tracks debt trends among households, companies and financial intermediaries.

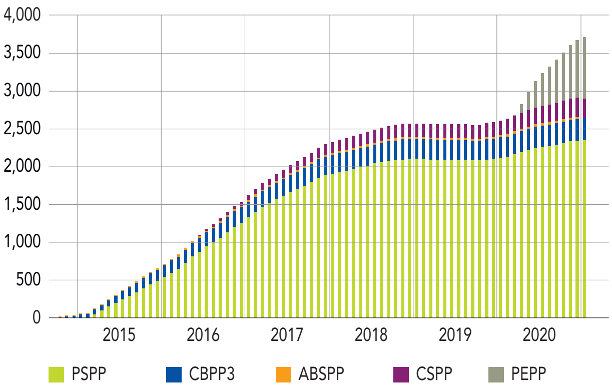
In 2010, within the Eurosystem, we were faced with the prospects of still-high interest rates with little impact on bank margins, while we had at our disposal inflexible and fairly conventional monetary policy instruments that put a *de facto* limit on the ability of monetary policy to exert influence on financial system risks. In 2021 the Eurosystem's toolbox looks significantly broader with the inclusion of forward guidance on interest rates, the deployment of asset purchase programmes and the introduction of targeted longer-term refinancing operations (TLTROs). In the meantime, the application of persistently accommodative monetary policy may have caused adverse effects for financial stability, including decreased bank profitability owing to ultra-low or even negative interest rates, overly search for yield behaviours by investors in a prolonged low-rate environment, easing of credit standards, increased leverage of non-financial agents as they took on more debt, and excessive risk premium compression in some market segments.

If financial instability were to impact asset prices, the solvency of the most heavily indebted companies and bank balance sheets (through an increase in non-performing loans), many monetary policy transmission channels would be threatened.

In support of a principle of coordination: use the wide array of monetary policy instruments to capture financial stability considerations more effectively

The need to counter the risks to the euro area inflation outlook and the monetary policy transmission mechanism, which have been exacerbated by the Covid-19 crisis, fully justifies a highly accommodative monetary policy. There can be no question of tightening policy in the name of financial stability, as called for by those who advocate for "leaning against the wind". The Eurosystem must seek to use instruments with the fewest adverse effects for financial stability, while potentially even introducing ad hoc mechanisms to mitigate such effects. To give an example, the *tiering* mechanism, under which a portion of excess reserves held by banks with the Eurosystem earn a higher rate of interest than the deposit facility rate, offers a way to exempt a portion of banks' excess reserve holdings with the Eurosystem from negative interest rates and to reduce the compression of net interest margins, so safeguarding the profitability of the banking sector in the low interest rate environment. Application of this mechanism allows monetary policy to target price stability without undermining financial sector stability.

C1 Asset purchase programmes conducted by the Eurosystem
(outstanding amounts in EUR billions)



Source: European Central Bank.
Note: PSPP: Public sector purchase programme. CBPP: Covered bond purchase programme. ABSPP: Asset back securities purchase programme. CSPP: Corporate sector purchase programme. PEPP: Pandemic emergency purchase programme.

1 Article 127(5) of the Treaty on the Functioning of the European Union.

2 European System of Central Banks.

In another example, TLTROs, which carry extremely low interest rates, exclude home loans to limit the potential contribution of monetary policy to residential property inflation, which would increase the risk of a bubble. Last but not least, the Eurosystem excludes purchases of equities and bank bonds, which could undermine the market discipline of financial institutions.

Integrate monitoring of financial stability risks in the conduct of monetary policy

It is vital, at very least, to continue to prioritise the use of monetary policy instruments that have the least adverse impact on financial stability, assuming identical effects on price stability. But we must also move beyond the traditional principle of keeping monetary and macroprudential policy strictly separate. Without calling into question price stability as the end goal of monetary policy or the role of macroprudential policy as the first line of defence in dealing with financial imbalances that prevent the transmission mechanism from functioning effectively, the conduct of monetary policy should include formal monitoring of financial stability risks, given their importance to monetary policy transmission and the effects on growth and inflation.

Until now, euro area monetary policy has been organised around two pillars: an economic analysis, which assesses the short- to medium-term determinants of economic developments and justifies a target interest rate, and a monetary analysis, whose role has lessened greatly over time but that takes a longer-term view, harnessing information gleaned from the linkage between money supply and prices. The second pillar – monetary analysis – needs to be overhauled and expanded to encompass an analysis that assesses financial imbalances and their subsequent effects on production and inflation: asset prices (property and/or equities) or trends in lending to households and companies could be assessed, for example.

Financial stability considerations would therefore be included as an explicit part of the monetary policy stance and would, in practice, be captured within a single, clear and transparent framework. This framework would have the advantage of formalising the analyses, which are already carried out in practice, that underpin choices in terms of monetary policy instrument combinations; these analyses would be guided by the intent to maximise the impact on inflation while minimising extreme side effects for financial stability.

2 Coordinate macroprudential policy at European and domestic levels to improve effectiveness

Integration of financial stability considerations into euro area monetary policy would need to be adjusted to reflect the geographical reach of the risks associated with identified vulnerabilities and would not call into question the need for macroprudential policy. The national macroprudential framework should still be able to deal with a risk that is confined to a given country. If a risk is specific to one country but could have consequences for neighbours, it should be possible to address this risk through a European macroprudential framework supplementing the domestic one. Meanwhile, a major shared risk for the entire euro area with a material impact on growth and consumer price indices would naturally be addressed by the single monetary policy. To achieve this optimal allocation between monetary and macroprudential policy, however, the macroprudential component needs to be strengthened, first and foremost on the European institutional side.

Institutional arrangements are sometimes too complex for macroprudential policy

Macroprudential policy governance takes various forms around the world: some countries entrust it to a political authority while others rely on their central bank, via a dedicated committee or an interagency committee on which the central bank participates.[3] This vacillation reflects a duality: macroprudential decisions have considerable political sensitivity – think of measures relating to housing loans – while also involving a significant technical element. Political governance thus comes with the risk of inaction while central bank governance may entail the risk of a lack of legitimacy.

Because of this, France uses a combined approach, which it has judiciously adjusted with use. the HCSF, chaired by the Finance Minister, acts as the macroprudential authority in this system; the Governor of the Banque de France sits on the council and has sole power to propose decisions, while the chairs of three French supervisory authorities, the *Autorité de contrôle prudentiel et de résolution* (ACPR – Prudential Supervision and Resolution Authority), the *Autorité des marchés financiers* (AMF – Financial Markets Authority) and the *Autorité des normes comptables* (ANC – Accounting Standards Authority), are also on the council. They are joined by three external members, each of whom is an independent and recognised economist.

The national-level arrangements are supplemented by those at European level. The goal of having monetary policy do a better job of considering financial stability requires coordination with the European macroprudential framework. This already exists: the European Central Bank (ECB) has top-up powers authorising it to tighten some macroprudential measures adopted by national authorities if these are deemed insufficient. Meanwhile, coordination and cooperation between national authorities is done via the ESRB,[4] which is chaired by the President of the ECB.

Strengthen the European component of macroprudential policy

Specific national features may persist that warrant non-uniform tools (for example in the real estate sector), but a European framework should be synonymous with transparency, enhanced cooperation and greater effectiveness in preventing risks from spreading, particularly in an economic and monetary union. Hence the idea of going further to ensure that financial integration corresponds to making the European financial system more resilient. Yet this must not be at the cost of complexity, which can make it harder to properly identify different parties' responsibilities and or result in cumbersome procedures that might interfere with the agility needed when crises arise.

The recent review of European banking sector regulations raised the level of harmonisation of the macroprudential framework. The European Commission could go even further during the review scheduled for 2022, notably in terms of measures covering borrowers. These measures could be integrated within CRD[5] VI, in order to provide all European Union countries with shared and transparent tools, facilitating their Union-wide adoption and reciprocity: this would represent encouraging progress towards a European macroprudential policy.

The way that macroprudential policy is essentially nationally organised at present is suited only to configurations involving internal shocks. Each country is supposed to be sufficiently equipped to counter these shocks or, in a best-case scenario, anticipate and prevent them. But it should be possible to deal at the European level with a risk that is identified as having systemic features, in order to ensure the financial stability of the entire zone. Such risks are growing increasingly likely owing to the significant interconnectedness of non-bank financial intermediaries and credit institutions within the European financial system. For this, the ECB (or the ESRB) should be given expanded macroprudential powers, based on a set of instruments defined at European level, to provide a platform for responsive and coordinated action. The Covid-19 crisis has highlighted room for improvement in several areas: granted, countercyclical buffers were released, but from quite different starting points; procedures involving European bodies and designed to mobilise certain macroprudential instruments take several months before implementation becomes effective. Experience tells us that this kind of red tape may discourage, without contributing much.

3 Strengthen the macroprudential framework and expand it to non-banks

Overall, the financial system has proved resilient in the Covid-19 crisis thanks to decisive interventions by government authorities, supervisors and central banks. But action in several areas could make the system work even better.

Little appetite for microprudential capital buffers argues for more extensive deployment of macroprudential buffers

Thanks to regulatory reforms introduced in the wake of the 2008 financial crisis, banks had much higher solvency ratios in 2020 than they did during previous crises. This was a decisive advantage, allowing banks to provide sustained financing to non-financial corporations. But solvency ratios were strengthened essentially by deploying capital buffers that authorities cannot release at the bottom of the cycle, unlike the countercyclical buffer.

Several obstacles to the use of microprudential bank buffers were identified, even after supervisory authorities relaxed their requirements, raising challenging questions about "buffer usability". First, banks are keenly attuned to the financial market pressure exerted through investors and credit rating agencies; banks fear that if they draw on their buffers, causing their solvency ratios to deteriorate, they might be stigmatised, with doubts arising about their soundness. Second, banks may be worried that supervisors could put restrictions on dividend payouts if solvency ratios deteriorate further. A third potential reason is linked to uncertainty among banks about coping with future requirements, post-crisis capital rebuilding imposed by authorities and the impact of increased future risks on their

3 Cf. *IMF-FSB-BIS* (2016).

4 European Systemic Risk Board.

5 Capital Requirements Directive.

ratios. We sought to alleviate these concerns at the meeting of the BIS[6] Group of Governors and Heads of Supervision (GHOS), which I chaired in November 2020, by providing clear guidance on the duration of these flexibilities: *"After the crisis, supervisors will provide banks with sufficient time to rebuild their buffers, taking account of economic, market and bank-specific conditions."*[7]

Prudential authorities therefore had to communicate extensively on the desired use of these buffers or to lower the requirements of some microprudential instruments (for example Pillar 2 Guidance) that were not initially intended to be released countercyclically. The call to draw on buffers must necessarily be made (and was partly made) in a coordinated manner across jurisdictions to prevent the risks of stigma and ensure a global level playing field.

Countercyclical macroprudential buffers must be strengthened without raising the total level of regulatory requirements provided for under the Basel III regulatory framework. This entails making choices between the size of existing buffers and the countercyclical buffer, which is designed to be released during times of stress. Countercyclical buffers that are always available, and hence strictly higher than zero, outside of crisis periods, would be a vital macroprudential tool, not only during crises that are endogenous to the financial system, but also during exogenous shocks, such as the Covid-19 pandemic.[8] The ECB should also be able to release buffers in a uniform and coordinated manner within the euro area, which would provide an effective pan-European macroprudential tool.

In France, we enhanced our credibility by showing that we would not hesitate to release the available countercyclical buffers when this seemed necessary: at my proposal, the HCSF took this step on 18 March 2020. In due course, once the crisis is over, we should also be able to step up use of this instrument. For this, however, the microprudential supervisor, i.e. the ECB via the Single Supervisory Mechanism (SSM) for Europe, must agree to lower its own capital requirements by an equivalent amount, but there are regrettably no signs of this happening.

Establish a macroprudential framework for the non-bank sector

Brisk growth in the financial cycle has paralleled financial regulation efforts at a global level since 2008, spurring, among other things, the emergence of the non-bank financial institution (NBFI) sector. The main non-bank financial institutions are insurance companies, pension funds, money market investment funds and other investment funds. The latter have seen the swiftest business growth, with the total value of assets in this sector swelling globally from EUR 11 trillion in 2008 to EUR 45 trillion in 2019.[9]

Owing to the rise of non-bank intermediation and, in particular, the growth of the investment funds sector, some financial activity has shifted to participants that make up a larger and less uniform population than that of the banking sector, but that respond in many cases to identical trends and whose effects may be procyclical. It is also their degree of interconnectedness that creates the need to develop a macroprudential framework for these participants that captures their systemic nature. Non-bank intermediaries are closely interconnected with each other and with banks, through direct exposures but also indirect exposures, notably via conglomerate structures and shared asset holdings. Moreover, in a low interest rate environment, these participants may have an incentive to hold riskier and less liquid assets while using leverage.

The Covid-19 crisis exposed the vulnerabilities of investment funds, especially money market funds, as well as the shortcomings of existing regulatory frameworks. The market finance sector must be sufficiently resilient to be able to absorb shocks without transmitting them to the wider financial system, much less to the real economy. Central bank action was decisive, notably in providing liquidity to short-term funding markets, in areas where money market funds are most active in normal times and where their withdrawal at the height of the crisis could have had a procyclical impact by eroding the liquidity available to non-financial corporations.

However, there are gaps in the existing prudential framework for money market funds, as it applies solely to the individual situation of each fund and fails to integrate the negative externalities that fund activities entail for the wider financial system. This creates liquidity risks for the real sector, which relies on funds for a growing share of its financing. Primordial improvements to the existing regulations include strengthening liquidity buffers while empowering the regulator to relax these constraints in times of stress: this should form the first line of macroprudential defence, to be used before turning to the central bank's last-resort support. These instruments need to be designed at a European level, given the NBFI sector's significant level of European integration, and in accordance with Europe's goal of building a capital markets union. An international approach would also make sense, given the high level of interconnectedness and dependency beyond Europe's borders. US authorities should take a more active role in this regard, alongside their European counterparts, to ensure that their asset management industry develops in a manner consistent with financial stability.

In circumstances where the situation of money market funds could pose major risks to growth and price stability in the euro area, monetary policy must be ready to intervene on an exceptional basis. However, implementation of macroprudential measures at European level should be a prerequisite to prevent moral hazard.

Conclusion

The goal of more effectively ensuring financial stability over the coming years is an ambitious project requiring action on three fronts:

- better coordinate macroprudential and monetary policy,
- strengthen the European component of macroprudential banking policy,
- and, most importantly, do a better job of capturing the NBFI sector in the macroprudential policy framework.

Make no mistake: since the global financial crisis of 2008, we have considerably strengthened bank regulation and our macroprudential policies in this sector. But the 2020 crisis showed that a missing link remains in the shape of macroprudential rules and tools for the **non-bank sector**. As this sector grows in importance, it is crucial to mitigate its risks, which concern liquidity much more often than solvency. This is the new frontier that we must cross as we build on progress towards a safer financial system, within Europe and around the world.

6 Bank for International Settlements.

7 GHOS (2020), *Governors and Heads of Supervision commit to ongoing coordinated approach to mitigate Covid-19 risks to the global banking system and endorse future direction of Basel Committee work*, press release, November.

8 In the event of a sharp financial sector reversal, banks would see their requirements decrease further, giving them greater room for manoeuvre to support credit. Similarly, during a phase when risks are accumulating, macroprudential authorities could increase requirements more significantly to make banks more resilient.

9 Estimate for the euro area and 21 other jurisdictions accounting for 80% of global GDP (cf. FSB, *Global monitoring report on non-bank financial intermediation*, 2020).

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