



Central Bank of Ireland response to the European Commission targeted consultation on improving the EU's macroprudential framework for the banking sector

The Central Bank of Ireland (Central Bank) welcomes the opportunity to provide views and insights from its experience with the European macroprudential framework for banks to date. The costs of financial crises on society are large and persistent. In light of these societal costs, the global financial crisis over a decade ago led to widespread reforms in the global and European financial architecture. In our view, the development and operationalisation of an effective macroprudential framework in Europe has been a critical pillar of those reforms.

This has entailed a shift in regulatory thinking over the past decade. Macroprudential policy focuses explicitly on risks to the provision of services *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.

While the macroprudential framework in Europe has yet to operate through a full financial cycle, much experience has been gained since the introduction of CRD IV/CRR, including the operation of the framework during the COVID-19 pandemic. This experience provides a valuable basis for considering areas where targeted enhancements to the legislative framework could be made. An enhanced macroprudential framework would strengthen financial stability across the European Union and in its Member States. By reducing the likelihood or impact of costly financial crises, an effective macroprudential framework in Europe entails benefit to society as whole.

The perspectives of the Central Bank are informed by our experiences with macroprudential policy over the past decade, in the context of the nature of the Irish economy and financial system. The Irish economy is one of the most open economies in the world for trade and finance. This openness is a core component of the Irish economic model and has yielded substantial benefits. Yet these 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. The Irish economy is also more prone to structural macroeconomic shocks, such as abrupt shifts in international trading arrangements. Further, being part of a monetary union means that monetary policy has limited capacity to respond



to local shocks to financial conditions. Hence, the Central Bank views the implementation of macroprudential policy appropriate to domestic conditions as critical to the overall policy framework to achieve macroeconomic stability.

The comments below are targeted at those aspects of the framework which are viewed as most important and relevant in the context of achieving this objective of financial stability contributing to macroeconomic stability. More broadly, the Central Bank also supports efforts towards reducing complexity within the framework where possible.

Capital buffers

The countercyclical capital buffer

- The Central Bank's strategy around – and the actual setting of – the countercyclical capital buffer (CCyB) in the years before the COVID-19 pandemic emphasized the importance of building resilience early on in the cycle. The economic shock arising from the COVID-19 pandemic – while not a traditional cyclical downturn – demonstrated the benefits of building releasable capital buffers in 'good' times, to enable the banking system to absorb adverse shocks and maintain the provision of financial services to the broader economy in 'bad' times. Indeed, there is emerging evidence that the release of macroprudential buffers supported/facilitated lending through this period.¹
- In that context, the Central Bank would be particularly supportive of legislative amendments that more explicitly broaden the focus of the indicators around the CCyB setting, beyond those relating to excessive credit growth and the credit-to-GDP gap, to cyclical systemic risk more generally. This would provide authorities additional flexibility to build resilience in the face of rising cyclical risks. This would be further facilitated by a more explicit acknowledgement that authorities need to take a forward-looking perspective on the potential emergence of cyclical risks. The latter point is particularly important in the context of the lags associated with counter-cyclical capital policy, especially in the upswing of the cycle.

Other systemically important institutions buffer

- The other systemically important institution (O-SII) buffer provides an additional layer of loss-absorbing capacity for institutions which, due to the scale or nature of their business,

¹ See from example [ECB 2021](#), [ECB 2020](#), [Banco de Portugal 2021](#), [BCBS 2021](#), [Bergant and Forbes 2021](#).



would risk posing a greater adverse impact on the economy or the rest of the financial system in case of failure. As such, the O-SII buffer is a critical component of the overall macro-prudential framework and its effective implementation is necessary to safeguard financial stability in the European Union.

- With a view to enhancing its effectiveness, there is merit in further progressing the development of the O-SII policy regime for the EU. Specifically, we would support further work to consider a joined up framework that would provide a consistent approach to the assessment of systemic importance across both O-SII identification and buffer setting, potentially including the introduction of a floor methodology. In doing so, a focus should be placed on reviewing how the EBA scoring methodology assesses systemic importance, for the reasons outlined below. More broadly, like all macroprudential measures, there should be sufficient scope for judgement by macroprudential authorities in setting O-SII buffers.
- Ireland is relatively unique in the European Union in terms of the make-up of the national banking sector. Within the Irish banking system, there is one cohort of institutions primarily providing financial intermediation services to the domestic economy and a separate cohort of institutions, which play a more limited role in the domestic economy, but are important providers of financial intermediation services to the broader European economy.
- This heterogeneous make-up of the banking sector has implications for the identification of, and setting of buffers for, systemically important institutions, as the channels through which these different types of institutions can affect systemic risk vary. Specifically, some institutions are more relevant from the perspective of the domestic economy, while others are more relevant from the perspective of their interconnectedness with the broader financial system and/or the overall European economy.
- In that context, our experience is that the EBA scoring methodology in its current form has some limitations. In particular, for banking sectors like Ireland, the scoring methodology (which is relative to the national banking system) can lead to situations where the use of certain indicators within the framework can result in an over or under estimation of systemic importance. It is due to these limitations that the Central Bank, therefore, does not apply a mechanical link between the EBA score and O-SII buffers. An effective framework would provide a consistent approach to the assessment of systemic importance across Europe, while acknowledging the flexibility required to capture the different channels through which this can operate.



Borrower-based measures (BBMs)

BBMs are an essential element of the overall macroprudential toolkit. Indeed, in our judgement, the BBMs that have been in place in Ireland since 2015 have played a critical role in safeguarding the resilience of both lenders and borrowers and in guarding against a re-emergence of an unsustainable credit-driven housing boom. Ensuring a minimum set of BBMs is available and useable in all Member States, something which is not currently the case, is a worthy policy objective. Indeed, if operationalised appropriately, it has the potential to enhance financial stability, both in individual Member States and across the European Union.

However, it is important to note that any European framework for BBMs will need to be designed in a manner which achieves those benefits, without diminishing the strengths of national measures and frameworks which are already in place. Within any European framework for BBMs there will be a strong need for both national governance and national flexibility, to guard against the risk any European framework, if not designed appropriately, could dilute either the effectiveness or the legitimacy of measures that have already been introduced at a national level.

Fundamentally, mortgage markets across European are still very heterogeneous, reflecting a number of factors: legal systems, tax regimes and even local cultural practices. As a result, it is of paramount importance that BBMs are tailored to national markets, to ensure appropriate design and calibration; to reduce the risk of leakages and circumvention; and to allow for a strong governance framework with appropriate accountability for domestic macroprudential authorities.

In this regard, a key principle behind the development of any EU framework should be that it is flexible enough to incorporate existing national frameworks for BBMs, which have been specifically designed to acknowledge these national circumstance. If this were not the case (and existing national frameworks had to adjust due to insufficient flexibility in an eventual EU framework), there could be significant costs, which would have the potential to impact the overall cost-benefit balance of the policy initiative from the perspective of the EU as a whole.

Specific observations:

Scope of application

- The BBMs currently in place in Ireland apply to all lenders operating in the State, where a lender is defined as any regulated financial institution that provides a housing loan to a borrower. The inclusion of non-bank lenders in Irish legislation underpinning the BBMs is



an essential element of the macroprudential framework, as non-bank lenders have become an increasingly important source of new mortgage lending in recent years. Specifically, between 2017 and H1 2021, the share of non-bank loans originated in the Irish mortgage market increased from 1 per cent to just over 12 per cent.

- In order to maximise effectiveness, it is therefore important that both bank and non-bank lenders should fall under the scope of BBMs in any European framework. Limiting BBMs to banking institutions only would have the potential to weaken the effectiveness of existing national measures and create opportunities for significant leakages.

Definitions

- The use of definitions, and whether these definitions represent minimum definitions required of Member States, will require very careful consideration. As discussed above, we believe that a key principle behind any EU-wide framework for BBMs should be that it is flexible enough to encompass the measures that are already in place in jurisdictions that have activated BBMs.
- Factors such as the legal systems of different member states, taxation systems, the nuances of individual banking systems as well as cultural norms will affect the definitions that are most appropriate in different member states. The Central Bank has discussed some of these issues in its recent [consultation paper](#). For example, regarding the definition of income and whether this should be on a gross or a net basis, one key consideration is the interaction with the tax system and how different options could impact different cohorts of borrowers (e.g. single or joint applicants). In addition, there is the potential that the use of net income, with its direct link to national taxation policy, could contribute to pro-cyclicality, as experience of the past two decades in Ireland suggests that tax policy has been cyclical to economic conditions.
- In that context, it is important that Member States retain the ability to adapt borrower based measures to the individual characteristics of each country, both in terms of definitions and in terms of the precise income-based and collateral-based tools (e.g. Loan-to-Income versus Debt-to-Income). Given the variability of how different instruments work in practice, any EU framework should explicitly provide for Member States to retain flexibility to facilitate the use of a wide variety of instruments, with the ability to tailor the BBMs implemented to their individual country context.



Commercial Real Estate

- At this stage, the Central Bank believes that it would be premature to seek to adopt borrower-based measures for commercial real estate (CRE) lending into the EU macroprudential framework. Owing to significant data gaps, greater market complexity and the limited implementation of such measures internationally, experience with BBMs for commercial property lending is much less extensive than on the residential side. To this end, initiatives such as the ESRB Recommendation on the closing of real estate data gaps, which aim to gather data on market conditions and the funding/holding of CRE assets by both banks and non-bank entities, should help improve the quality and availability of CRE data, upon which effective policies can be based in future. Moreover, the inherent complexity of how commercial property markets function across Europe, e.g. the degree of cross-border interactions and/or the growing role of non-banks, add to complications in the design of appropriate macroprudential instruments and warrant additional consideration. Given these challenges and the nature of CRE market, it is an area which would certainly benefit from collective progress at a European level, with a view to potentially being in a position to provide authorities with a consistent set of instruments in the future.

Non-bank financial intermediation

- The Commission's review focuses on the macroprudential framework for the banking sector. Nevertheless, a key structural trend over the past decade – in Europe and internationally – has been the growth of non-bank financial intermediation. This is expected to continue, including in the context of the Capital Markets Union. Non-bank financial intermediation provides a valuable alternative to bank finance for many businesses and households, supporting economic activity. Nevertheless, like all sources of financial intermediation, it can also contribute to a build-up of financial vulnerabilities, which need to be monitored and – if needed – addressed.
- In that context, a key priority for the future development of the macroprudential policy framework in Europe is designing and operationalising an effective macroprudential approach for the non-bank financial intermediation sector, including investment funds. In the absence of progress in this area, the overall macroprudential framework will remain incomplete and less able to target potential systemic vulnerabilities across the financial system. This could also spill over to the banking sector. For example, excessive risk-taking among non-banks, without appropriate regulatory risk mitigants, may spill over to the



banking system in times of stress, given the interconnectedness between these sectors. The nature of the financial system is changing and, if we were to stand still, our framework risks not being fit for purpose in years to come.