Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2014

A Macro-Prudential Policy Framework for Ireland

Contents

1. Introduction 1
2. Objective of macro-prudential policy 2
3. Macro-prudential powers and instruments 2
3.1 Instruments to mitigate excessive credit growth/leverage 5
3.2 Instruments to mitigate excessive maturity mismatch 8
3.3 Instruments to limit direct and indirect exposure concentrations 8
3.4 Capital surcharges for systemically important institutions 9
4. Decision-making process 9
5. Conclusions 12
References 13
Glossary 14
Annex 1: Macro-prudential mandate of the Central Bank of Ireland 16
Annex 2: Instruments in CRR/CRD IV 19

1. Introduction

The global financial crisis has re-focused policymakers' attention on the risk of instability developing across the financial system. For the most affected countries, the crisis entailed substantial costs in the form of recapitalisation of distressed banks, disruption to lending activity, a sharp rise in unemployment and a decline in economic growth. Since the crisis resulted from an excessive expansion of credit and of the financial system more broadly, across the world authorities responsible for promoting financial stability are taking measures to reduce the risk of such systemic crises reoccurring through the enactment of macro-prudential policies. These regulatory policies are aimed at the promotion of the stability of the financial system as a whole.

Given its statutory financial stability mandate, the Central Bank of Ireland (hereafter 'Central Bank') has an important role in macro-prudential policy in Ireland. The Central Bank Act, 1942 (as amended by the Central Bank Reform Act, 2010), states that the "stability of the financial system overall" is an objective of the Central Bank. The Central Bank is also the national macro-prudential authority for the purposes of the European Systemic Risk Board's (ESRB) 2011 Recommendation[1] and is the *designated* national authority responsible for certain macro-prudential powers in the Capital Requirements Regulation and Directive[2] ('CRR/CRD IV'). Annex 1 further discusses the legal basis for the Central Bank's powers in this area.

The Single Supervisory Mechanism (SSM) becomes operational in November 2014 at which time the European Central Bank (ECB) will have supervisory powers over banks in the Euro Area and in opt-in Member States. The ECB will also have a macro-prudential supervisory mandate. Macro-prudential policy will, therefore, become a shared competency between the Central Bank and the ECB.

[It should be noted that this document focuses on macro-prudential policy issues at national level and therefore is distinct from the C*omprehensive Assessment* currently being carried out by the ECB, which focuses on the financial soundness of individual banks.]

[1] Recommendation of the ESRB of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3), OJ 2012/C 41/01.
[2] Regulation (EU) No.575/2013 was directly applicable in Member States when the legislation entered into force in January 2014 but Directive 2013/36/EU required transposition into national law. In Ireland, this was achieved via S.I.No.158 of 2014, European Union (Capital Requirements) Regulations 2014.

In this document an overview of the Central Bank's macro-prudential policy strategy is presented, covering the objectives, the instruments and decision-making process involved. A glossary of technical terms and abbreviations is also included.

2. Objective of macro-prudential policy

The objective of macro-prudential policy is to mitigate the risk of a disruption to the provision of financial services, caused by an impairment of all or parts of the financial system, with serious negative consequences for the real economy.[3] This risk is known as *systemic risk*. The initial focus is on the banking sector given its prominent role in the intermediation process in Ireland and with new European legislation on macro-prudential instruments being mainly for this sector.[4]

To promote financial stability in Ireland, macro-prudential policy aims to strengthen the resilience of the domestic banking system so that it can withstand adverse movements in credit and property prices, and other macroeconomic shocks. Such policy measures will be forward-looking and seek to reduce the potential for imbalances to accumulate, given that they could lead to financial distress.

Intermediate objectives are necessary to monitor progress toward achieving these high-level goals. Such objectives for the banking sector include:[5]

- To prevent excessive credit growth and leverage;
- To prevent excessive maturity mismatch and market illiquidity;
- To limit direct and indirect exposure concentration; and
- To reduce the potential for systemically important banks to adopt destabilising strategies and to mitigate the impact of such actions.

3. Macro-prudential powers and instruments

The Central Bank has a range of instruments at its disposal to address systemic risk in the banking sector. It is useful to distinguish between those

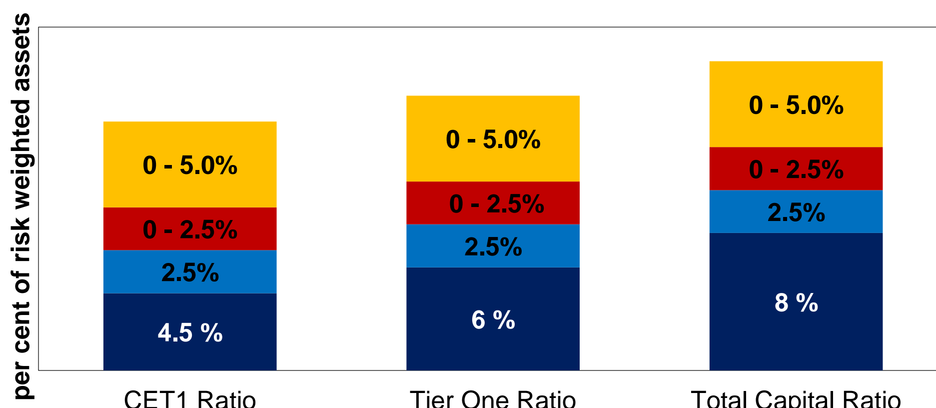
[3] ESRB (2014).
[4] Certain investment firms are also covered by the legislation. For details, see the Central Bank's Implementation Notice of Competent Authority Discretions and Options in the CRR and CRD IV, and the consultation process on certain derogations for SME investment firms link (CBI, 2014c)
[5] Based on work by the European Systemic Risk Board in ESRB (2014a) and ESRB (2014b).

that target the balance sheet of the banks (i.e., capital, liquidity-based tools and large exposure limits) and those that affect the terms offered to borrowers for lending (i.e., credit-based tools).

The legal basis for the Central Bank's power to deploy macro-prudential instruments arises from the CRR/CRD IV[6] and from existing national legislation that sets out the Central Bank's financial stability mandate (See Annex 1).

The CRR/CRD IV provides the Central Bank with a number of instruments and discretions to address its macro-prudential mandate. Under CRD IV, the Central Bank can apply a number of capital buffers, comprised of common equity tier one as a percentage of risk-weighted assets, as an add-on to minimum requirements to address system-wide risk (Chart 1).[7] The details of these capital buffers are discussed below.

Chart 1: Regulatory Capital Ratios under CRR/CRD IV



Source: Adapted from European Commission (2013)
Notes: O-SII refers to other systemically important institutions, G-SII refers to global systemically important institutions and CET1 is common equity Tier 1. Chart excludes additional Pillar 2 requirements that could be set following the supervisory review process and banks' own voluntary capital buffers.
* Possible upper bounds but can be higher. The SRB may be cumulative with the O-SII/G-SII buffers if it applies to domestic exposures only.

[6] As transposed by S.I. 158 of 2014, European Union (Capital Requirements) Regulations 2014.
[7] The list of capital buffers include the capital conservation buffer, countercyclical capital buffer, the global systemically important institution buffer and the other systemically important institution buffer. The systemic risk buffer under Article 133 is currently not available in national law but may be introduced at a later date at the discretion of the Minister for Finance if structural systemic risks emerge.

A range of micro-prudential requirements can also be tightened if the supervisory review process reveals that a bank or a group of banks is contributing to, or is exposed to systemic risks. The Central Bank is permitted to impose stricter requirements for the level of own funds (i.e., minimum capital requirements), large exposure limits, liquidity requirements, real estate risk weights, and measures for intra-financial exposures. A higher capital conservation buffer requirement[8] and increased disclosure requirements can also be implemented if required for macro-prudential purposes under the CRR.

National legislation provides the basis for introducing other tools that can achieve a macro-prudential objective. Some examples are restrictions on lending based on loan-to-value (LTV) ratios, loan-to-income (LTI)/debt-service-to-income (DSTI) ratios and simple funding instruments (e.g., loan-to-deposit ratio targets). The Central Bank can also issue guidelines and recommendations on relevant financial stability issues.

Table 1 links the intermediate objectives with potential instruments to address systemic risk in the banking sector based on ESRB (2014). Some instruments can be used to achieve several intermediate objectives. Each objective and related instruments are discussed in turn in sections 3.1. to 3.4.

[8] The mandatory capital conservation buffer, which will be phased in from 2016 is not discussed in this document as it does not have a pure macro-prudential focus. Its role is to "conserve" high quality capital and will be set at 2.5 per cent following a phased introduction period. If the Common Equity Tier 1 Ratio (CET1) breaches 7 per cent and some of the capital conservation buffer is eroded, there are immediate restrictions on dividend and bonus payments to preserve the capital ratio. See CBI (2014a) for further details. However, a higher level of the requirement can be set in response to macro-prudential risks under the CRR (Article 458).

Table 1: ESRB indicative list of macro-prudential instruments

Intermediate objective	Instruments
1. Mitigate and prevent excessive credit growth and leverage	i. Countercyclical capital buffer ii. Sectoral capital requirements iii. Macro-prudential leverage ratio iv. Systemic Risk Buffer v. Loan-to-value requirements vi. Loan-to-income / debt (service)-to-income requirements
2. Mitigate and prevent excessive maturity mismatch and market illiquidity	i. Macro-prudential adjustment to liquidity ratio (e.g., liquidity coverage ratio) ii. Macro-prudential restrictions on funding sources (e.g., net stable funding ratio) iii. Macro-prudential un-weighted limit to less stable funding (e.g., loan-to-deposit ratio) iv. Liquidity charges or liquidity buffers
3. Limit direct and indirect exposure concentration	i. Large exposures restrictions ii. Capital-based instruments (e.g., systemic risk buffer, increased own funds)
4. Limit the systemic impact of misaligned incentives with a view to reducing moral hazard for systemically important banks	i. Systemically important financial institution (SIFIs) capital surcharges ii. Systemic risk buffer iii. Higher liquidity requirements for SIFIs

3.1. Instruments to mitigate and prevent excessive credit growth and leverage

(a) Powers currently available to the Central Bank under Irish national law.

- *Countercyclical capital buffer*

The countercyclical capital buffer (CCB) is a new instrument under CRD IV and will require banks to set aside additional common equity tier one capital during periods of strong credit growth and growing systemic risk. This buffer can be released during economic downturns to prevent undue restrictions in the supply of credit to the private sector. The CCB aims to promote banking sector resilience by protecting it against potential losses and ensuring a stable provision of credit over the economic cycle.

This instrument will be available from 1 January 2016 with a phased introduction period thereafter. The CCB will apply to exposures of Irish counterparties and can be set between 0 and 2.5 per cent of risk exposures.[9] From 2016 the CCB requirement will be set on a quarterly basis with the rate and any relevant information, such as the deviation of

[9] The CCB rate can be set higher if warranted by financial stability circumstances. From 2019, reciprocity will be mandatory up to 2.5 per cent and voluntary above 2.5 per cent among EU Countries.

the credit-to-GDP gap from its long-run trend and other indicators, published on the Central Bank's website. Once announced, banks will generally have twelve months to meet the new requirement while a reduction in the rate will be applicable immediately.

- *Sectoral capital requirements*

A targeted increase in capital requirements can be applied to any category of loans for which strong growth gives cause for concern. Examples include mortgage lending, unsecured consumer credit, corporate lending or specific corporate segments, such as lending to commercial property.

Sectoral capital requirements can be applied by either increasing micro-prudential capital requirements for exposures to a particular sector or asset class or by raising the risk weights associated with a particular sector or asset class.[10] Lower bounds on risk weights or on loss-given-default parameters applied to certain sectoral credit exposures when calculating capital requirements could also be set.

- *Leverage ratio*

The CRR/CRD IV also introduces a leverage ratio as a potential back-stop measure to complement more risk-based measures of capital adequacy. The aim is to reduce excessive growth in assets relative to capital by banks. Such actions by banks increase the risk of a destabilising deleveraging process in a downturn. The leverage ratio is defined as the ratio of tier one capital to total exposures, with the denominator covering both on- and off-balance sheet activities.

The ratio is currently only a reporting requirement and is subject to an observation period until mid-2016. The ratio may become a binding requirement by 2018 following review and calibration at European level. Banks will be required to publicly disclose certain information on their leverage ratios from 2015.

- *Credit-based tools*

Property market developments can pose a number of risks to financial stability, especially if driven by excessive credit growth. Tools that focus on credit conditions offer a useful alternative or complement to capital-based measures to address such risks. Loan-to-value ratios involve the imposition of a cap on the size of a mortgage loan relative to the value of a

[10] See Annex 5 in CGFS (2010) for further details on operationalizing sectoral capital requirements.

property. A loan-to-income ratio restricts the size of a mortgage loan to a fixed multiple of household income, acting as a restraint on excessive repayment burdens and unsustainable increases in household debt. It is also possible to constrain the debt-service costs to income ratio which would act in a similar manner as the loan-to-income cap.

Lower loan-to-value ratios can increase the resilience of the banking system via a lower loss-given-default, while lower loan/debt service-to-income ratios can reduce the probability of default. As these policies tend to restrain mortgage credit growth during an upswing, the probability of unsustainable credit-driven property booms occurring is reduced.

(b) Powers which are provided for under EU Law but have not been transposed into Irish law to date

- *Systemic risk buffer*

Directive 2013/36/EU ('CRD IV Directive') allows member states the discretion to introduce a new systemic risk buffer (SRB) to address structural systemic risks (e.g., concentration risk). The SRB aims to prevent and mitigate long-term non-cyclical systemic or macro-prudential risks with the potential for serious negative consequences to the financial system and the real economy and which cannot be covered by other measures in the CRR. Although its primary objective is to deal with structural systemic risk, the SRB may also address cyclical risks if they lead to common exposures or excessive indebtedness. The SRB can be applied to an individual bank or to a set of banks.

While the SRB must be introduced at 1 per cent of the exposures to which the instrument applies, there is no upper bound on the buffer level. Given the instrument's flexibility, there is a need to avoid distortions to the domestic financial sector or to other jurisdictions in its application. To minimise cross-border effects, there are certain procedural notification and authorisation requirements at European level based on thresholds for this buffer.

The Government has not transposed the power to impose systemic risk buffers into Irish law to date, although it has discretion to do so at a future date. Currently, the Central Bank has the power to recognise SRB rates set by other Member States for the purposes of capital held by Irish banks against exposures in such jurisdictions.

3.2. Instruments to mitigate and prevent excessive maturity mismatch

Systemic liquidity risk materialises when banks' normal funding channels fail. A reliance on volatile sources of funding and a high degree of maturity mismatch increases this risk. Macro-prudential liquidity instruments aim to mitigate systemic liquidity risk. Both quantity-based (e.g., liquidity coverage ratio (LCR), net stable funding ratio (NSFR), loan to deposit (LTD), or loan to stable funding (LTSF) limits) and price-based (e.g., general liquidity surcharge and liquidity surcharge for systemically important institutions) instruments can be used to reduce reliance on vulnerable non-core funding.

Macro-prudential policy responses to liquidity risk can take the form of a time-varying buffer over the regulatory levels for both the LCR and the NSFR and other funding ratios. The LCR and the NSFR, though incorporated in CRR, are still in the process of being finalised at European level and are subject to an observation period. It is intended that the LCR will be fully implemented by 2018 following a phased introduction from 2015.[11] Work on the NSFR is less advanced. There is, however, a general requirement to hold sufficient liquid assets until the LCR enters into force in 2015 and a general rule on stable funding sources from 1 January 2016. The Central Bank has a liquidity framework in place to monitor liquidity risks on a bank-by-bank basis. Any evidence of systemic liquidity risk could prompt the Central Bank to introduce liquidity requirements for a group of banks.

3.3. Instruments to limit direct and indirect exposure concentrations

Restrictions on large exposures to particular sectors, asset classes or counterparties can be used to reduce concentration risk or counterparty risk and offer scope to mitigate the harmful effects of contagion in the event of default**.** A *large exposure* is defined under the CRD as an exposure equal to or exceeding 10 per cent of a bank's own funds. The 10 per cent threshold triggers monitoring by the Central Bank. From a micro-prudential perspective, banks are not permitted to have an exposure of more than 25 per cent of their own funds to any one client or group of clients.

A tightening of micro-prudential large exposures limits and/or higher capital requirements could be used as macro-prudential measures to address concentration risk.

[11] Under the CRR, the schedule for LCR implementation is 60 per cent in 2015, 70 per cent in 2016, 80 per cent in 2017 and 100 per cent in 2018.

3.4. Capital surcharges for systemically important financial institutions

An extra capital requirement for systemically-important financial institutions (SIFIs) would increase the resilience of these institutions to shocks, reducing the risk of a system-destabilising default. A SIFI is defined as an institution that, due to its size, complexity and financial links, cannot fail without serious repercussions for the financial system and economy. A SIFI surcharge can give banks an incentive to reduce their own levels of systemic importance by reducing the complexity and the scope of their activities.

In Europe, CRD IV introduces additional capital buffers for SIFIs such as the global systemically important institutions (G-SII) buffer and other systemically important institutions (O-SII) buffer. The G-SII buffer is a mandatory surcharge that will apply at the consolidated level of the most systemically significant cross-border banking groups from 1 January 2016 and will vary between 1 and 3.5 per cent depending on an institution's degree of systemic importance[12]. The optional O-SII buffer, which is capped at 2 per cent, will be applicable in Ireland from January 2016. The aim of the O-SII buffer is to reduce the potential impact of banks that are considered "too big to fail" within a country. The buffer can be applied to all or a subset of identified O-SIIs.

Liquidity instruments can also be used to increase the resilience of these institutions to sudden funding shortages and adapted to capture their individual contribution to systemic liquidity risk.

4. Decision-making process

The Central Bank will follow a number of steps when conducting macro-prudential policy. The process involves a continuous cycle of systemic risk assessment, instrument selection and calibration, policy implementation and communication, and policy evaluation (see Figure 1).

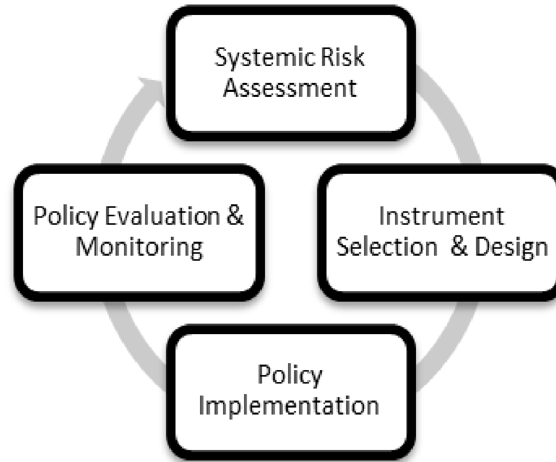
The cycle begins with risk identification and assessment. At this stage, the stability of the main sectors of the Irish financial system[13] and any potential inter-linkages with the domestic and international macro-financial environment are analysed. Statistical analysis, the semi-annual Macro-

[12] No Irish bank is currently categorised as a G-SIFI based on Basel Committee of Banking Supervision/Financial Stability Board's provisional list of G-SIIs.

[13] Households, firms, government, property, banks and non-bank financial intermediaries.

Financial Review[14], market intelligence and judgement perform important roles in this risk identification stage. This step culminates in a decision on whether macro-prudential intervention should be considered.

Figure 1: Macro-prudential policy cycle



Source: Adapted from ESRB (2014).

If there is evidence of systemic risk the Central Bank will select and design an appropriate macro-prudential instrument or combination of instruments. Economic analysis and legal powers guide these decisions. Considerations may include whether an instrument targets the specific risk identified; is proportionate to the level of risk; is relatively less prone to leakages; is transparent; causes limited negative distortions to the financial system; and has limited cross-border spill-overs. The legal basis for implementing an instrument determines the scope of application and so must be taken into account. If more than one instrument is necessary, appropriate sequencing of their deployment to prevent undue distortions to the financial system and to conform to the CRR/CRD IV will be considered.

Mapping indicators of systemic risk to the activation and calibration of specific tools will be a challenging task. Macro-prudential policy is a new area of responsibility for many central banks and limited experience with some of the new instruments implies that the net benefits of such measures are unknown. Therefore, qualitative analysis/judgement in combination with statistical analysis will be important when selecting instruments.

In step three, timing considerations will be important when implementing macro-prudential policy decisions, to ensure their maximum effectiveness.

[14] http://www.centralbank.ie/publications/Pages/MacroFinancialReviews.aspx

Deploying instruments too early or too late in response to identified risks entails costs. If instruments are put in place too early, market participants may circumvent the measure or there may be unintended economic effects but, equally, if instruments are deployed when systemic risks have already accumulated, their effects may be limited. The Central Bank also recognises that communication is an important part of the policy process and will undertake to alert all relevant stakeholders in a timely manner about any intended measures.

The multi-faceted nature of systemic risk implies that there will be interactions across a number of policy areas, including micro-prudential, monetary and fiscal. With its unitary structure, the Central Bank benefits from complementarities which can help avoid conflicts between micro- and macro-prudential supervision from emerging. The Central Bank will also monitor any interactions with other policy areas over the macro-prudential policy cycle. The Central Bank will deploy and release instruments within the confines of the respective supporting legislation and with due regard to the Constitution, the Treaty on the functioning of the European Union and the ESCB Statute.

International coordination is important given the possibility of cross-border effects[15]. The European Systemic Risk Board (ESRB) was established in 2010 to act as the macro-prudential oversight body in the European Union (EU).[16] To foster sound macro-prudential frameworks across Europe, the ESRB has issued recommendations on national macro-prudential mandates[17] and on the intermediate objectives and instruments of macro-prudential policy[18], with which national authorities have to *comply or explain*. To provide guidance to national policy makers, the ESRB has published a number of reports on macro-prudential policy and has adopted a coordination framework between national authorities and the ESRB on the procedures governing macro-prudential policy measures. The CRR/CRD IV mandates EU-wide coordination of certain policies (See Annex 2).

The introduction of the Single Supervisory Mechanism in Europe implies that there will be shared competencies for certain macro-prudential

[15] Macro-prudential policies may have both positive and negative spill-overs to other jurisdictions.
[16] See the ESRB homepage for more information: http://www.esrb.europa.eu/home/html/index.en.html
[17] Recommendation of the ESRB of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3), OJ 2012/C 41/01.
[18] Recommendation of the ESRB of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1), OJ 2013/C 170/01.

instruments. Within its area of competence, the ECB under SSM can apply stricter requirements to macro-prudential measures that are already in place at national level or could introduce one where one has not previously existed. Accordingly, there will be close cooperation between the Central Bank and the ECB on macro-prudential policy.

The final stage of the macro-prudential policy process is policy evaluation. The Central Bank will review the effectiveness of any deployed measure in addition to monitoring any unintended consequences on an on-going basis. It may be necessary to re-design a measure if conditions warrant. Countercyclical macro-prudential instruments will be released when appropriate to prevent excessive deleveraging with corresponding real effects.

5. Conclusions

Ireland's emerging framework for macro-prudential regulation is being articulated within a structure that has been defined by the European Systemic Risk Board, but which relies mainly on Irish national laws and institutions, especially the Central Bank.

Macro-prudential policy will not prevent future financial crises: it aims to reduce the probability and depth of such events. By focusing on the resilience of the domestic banking sector, it will complement the Central Bank's micro-prudential supervision model and the structural reform of the Irish banking sector such as the 2011 Financial Measures Programme[19].

[19] See the Central Bank's webpage on FMP for further details and CBI (2011).

References

CBI (2011), “The Financial Measures Programme Report” Central Bank of Ireland, March.

CBI (2014a), “Implementation of Competent Authority Discretions and Options in CRD IV and CRR”, Central Bank of Ireland.

CBI (2014b), “Guidelines on the LCR Calculations for the Interim Observation Period”, Central Bank of Ireland, May.

CBI (2014c), “Discretion for exemptions from capital buffers for SME investment firms from CRDIV/CRR”, Consultation Paper 81/2014.

CGFS (2012), “Operationalising the selection and application of macroprudential instruments”, CGFS Papers No. 48, Committee on the Global Financial System, December.

European Commission (2013), Frequently Asked Questions on CRD IV/CRR, March

ESRB (2011), “Recommendation on the macro-prudential mandate of national authorities”, Official Journal of the European Union (ESRB/2011/3)

ESRB (2013), “Recommendation on intermediate objective and instruments of macro-prudential policy”, Official Journal of the European Union (ESRB/2013/1).

ESRB (2014a), “Flagship Report on Macro-Prudential Policy in the Banking Sector “March 2014

ESRB (2014b), “ESRB Handbook on Operationalising Macro-Prudential Policy in the Banking Sector”, March 2014

Glossary

Basel III

A global regulatory framework for banks and banking systems, developed by the Basel Committee on Banking Supervision.

Banking Union

Banking union aims to foster financial stability in Europe and reduce the links between sovereigns and banks that emerged in the crisis. Within banking union, there will be a single supervisory mechanism and common recovery and resolution framework in the EU. See the European Commission website for more details; http://ec.europa.eu/internal_market/finances/banking-union/index_en.htm

Capital Buffer

The amount of capital which a financial institution needs to hold above minimum requirements, calculated through an assessment of risks. The CRD IV introduces a number of new buffers comprised of common equity tier one and which are expressed as a percentage of risk-weighted assets.

Capital Requirements Regulation and Directive IV

The European legislation, which governs minimum capital requirements for all credit institutions in EU Member States. Its provisions reflect, to a large extent, the rules laid down by the Basel Committee on Banking Supervision. The CRR/CRD IV came into force in Europe on 1 January 2014. The CRR was directly applicable from this date but the CRD IV required transposition into national law. Statutory Instruments S.I. 158 and 159 of 2014 respectively transposed the Directive and operationalised certain aspects of the CRR in Ireland. Further details are available from the Central's Bank's Implementation Notice.

Common Equity Tier One Capital

A measurement of a bank's core equity capital compared with its total risk-weighted assets. This is the measure of a bank's financial strength. There are strict criteria governing the type of capital instruments that can be considered as common equity tier one capital under the CRR.

Liquidity Coverage Ratio (LCR)

The LCR is defined as the ratio of high quality liquid assets to stressed net cash outflows over a period of 30 days. The CRR/CRD IV did not provide a detailed calibration of the ratio but empowered the European Commission to set the LCR requirement (via an EU Delegated Act), taking EU specific factors into account. There will be an observation period until this Delegated Act comes into force. See CBI LCR for further details of the Central Bank's approach to LCR calculations in the observation period.

Loss-Given-Default

The credit loss incurred on a loan if a creditor defaults.

Macro-Prudential (financial stability) analysis

A system-wide analysis of the financial sector and its inter-linkages with the macro-economy.

Macro-Prudential Policy

The implementation of specific instruments to reduce systemic risk and promote financial stability. In Ireland, macro-prudential policy aims to strengthen the resilience of the domestic banking system and reduce the potential for vulnerabilities that could cause financial instability to accumulate.

Micro-Prudential Supervision

The regulation and oversight of individual financial firms to ensure financial soundness.

Net Stable Funding Ratio (NSFR)

Under Basel III, the NSFR is defined as the ratio of available stable funding to the level of required stable funding. This ratio should not be less than 100 per cent. In Europe, the CRR introduces a reporting requirement for stable funding from 2014, and a general obligation from 1 January 2016, but it does not introduce an NSFR requirement. This requirement may be introduced in the coming years following review.

Probability of Default

Probability of default measures the likelihood that a loan will not be repaid and will fall into default.

Risk-weighted assets

A measure of the amount of a bank's assets or off-balance sheet exposures, weighted according to risk. This calculation is used in determining the capital requirement for a financial institution.

Single Supervisory Mechanism (SSM)

The SSM creates a new system of financial supervision comprising the European Central Bank (ECB) and the national competent authorities of participating EU countries. The stability and soundness of the European banking system and the closer financial integration at European level are the main aims of the SSM. The ECB will be responsible for the effective functioning of the SSM in cooperation with national competent authorities. The ECB will assume these responsibilities in November 2014. For more information see the following Central Bank webpage http://www.centralbank.ie/Pages/SingleSupervisoryMechanism.aspx

Systemic Risk

The risk of a systemic event. A systemic event comprises an impairment of all or parts of the domestic financial system leading to a disruption in the provision of financial services which has a negative impact on the real economy.

Abbreviations

CCB: Countercyclical capital buffer
CET1: Common equity tier one capital
CRR/CRD IV: EU Capital Requirements Regulation and Directive IV
DSTI: Debt service to income ratio
EBA: European Banking Authority
ECB: European Central Bank
ESRB: European Systemic Risk Board
EU: European Union
G-SII: Global Systemically Important Financial Institution
LCR: Liquidity Coverage Ratio
LTI: Loan-to-income ratio
LTV: Loan-to-value ratio
MFR: Macro Financial Review
NSFR: Net Stable Funding Ratio
O-SII: Other systemically important institutions
SIFI: Systemically important financial institution
SRB: Systemic risk buffer
SSM: Single Supervisory Mechanism

Annex 1: Macro-prudential mandate of the Central Bank of Ireland

The objective in Section 6A (2) (a) of the Central Bank Act, 1942 (as amended by the Central Bank Reform Act, 2010), in relation to the "stability of the financial system overall" gives the Central Bank of Ireland an important role in the area of macro-prudential policy in Ireland. This role is without prejudice to its responsibilities as part of the European System of Central Banks (ESCB). The objective in section 6A of the 1942 Act, therefore, must be qualified with reference to the ESCB and the achievement of the primary monetary policy objective of price stability.

Instruments

The Central Bank has a wide range of powers of macro prudential powers that assist in achieving the objectives of the Bank (including the stability of the financial system). These macro prudential powers derive from both European and Irish law. We have elaborated on this further below.

The Capital Requirements Regulation and Directive IV (CRR/CRD IV) introduced a number of new macro-prudential instruments and powers. Although the Regulation was directly applicable in Member States when the legislation entered into force on 1 January 2014, the Directive required transposition into national law. CRD IV was transposed into Irish law by the Minister for Finance on 31 March 2014. The Central Bank was designated as the authority with competence to perform the functions under the CRR and CRD IV including macro prudential powers such as imposing countercyclical capital buffer, systemically important institutions buffers and the ability to tighten a range of micro-prudential instruments under certain circumstances.

The Bank is also empowered under Part 6, Chapter 2 of SI No 158 of 2014, to implement a Pillar 2 measure to capture risks to which the institution might be exposed, taking into account the assessment of systemic risk concerns when undertaking the Supervisory Review and Evaluation Process. Some examples of Pillar 2 measures are additional own funds requirements, higher liquidity requirements, limitation of operations and specific treatment of assets and higher disclosure/reporting requirements.

The Central Bank (Supervision and Enforcement) Act 2013 also provided the Central Bank with a broad power to issue regulations under Section 48. Where it is in the interests of the proper and effective regulation of regulated financial service providers (for example the reduction of systemic

risk), the regulations may be used to achieve a macro prudential objective. An example of the use of the power of regulation in this way may be the imposition of caps on loan-to-value ratios and on loan-to-income multiples to achieve the objective of strengthening the resilience of the financial system so that is can withstand adverse movements in credit and property cycles. The procedure with regard to regulations involves consultation with the Minister for Finance. Regulations made under section 48 must be laid before each House of the Oireachtas.

Other examples of domestic legislative powers which could be used to achieve a macro-prudential objective are the powers to impose asset to liability ratios under Section 23 and 23A of the Central Bank Act 1971.

Cooperation

The Central Bank has statutory independence to carry out its macro-prudential responsibilities. Section 6(1A) of the Central Bank Act 1942 states "Nothing in the Central Bank Acts 1942 to 2010 affects the independence of the Bank, the Governor and the Commission required by the Rome Treaty and the ESCB Statute."

The Central Bank will cooperate with the ECB in the imposition of macro-prudential measures (See subsection below on the European context).

There are also legislative provisions for co-operating with a range of public bodies whose actions may have a material effect on domestic financial stability. Section 61E of the Central Bank Act 1942 requires the Central Bank to consult in relation to "ensuring the establishment and pursuit of consistent policies regarding the regulation of financial services in the State". The Central Bank has also entered into MOUs with certain bodies with respect to the exercising of functions, in particular with the Department of Finance. The Central Bank does not act in isolation from other bodies and other bodies have sole responsibility in areas of their competence e.g. the Department of Finance in relation to fiscal matters.

There are legal provisions in place, through Section 33AK of the Central Bank Act 1942, Section 54 of the Central Bank Reform Act 2010 and the EU Supervisory Directives, for sharing and exchanging information with other Member States and EU bodies and for co-operation with Members States and overseas authorities

European context

- ***European Systemic Risk Board***

The European Systemic Risk Board (ESRB) has a macro-prudential oversight role at European Union level. The ESRB can issue recommendations on an "act or explain" basis[20] to Member States. Two of these relate specifically to macro-prudential policy matters and are as follows;

(1) *Recommendation of the ESRB of 22 December 2011 on the macro-prudential mandate of national authorities (ESRB/2011/3), OJ 2012/C 41/01*

(2) *Recommendation of the ESRB of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1), OJ 2013/C 170/01*

The recommendation on the macro-prudential mandate is addressed to Member States and requires establishing the objective of macro-prudential policy as the stability of the financial system as a whole and ensuring that national institutional arrangements are sufficient to effectively meet this mandate. The Central Bank of Ireland is the national macro-prudential authority for the purposes of this recommendation. In its final report, the ESRB assessed that Ireland was overall largely compliant with this recommendation[21].

- ***Single Supervisory Mechanism***

Article 5 of the SSM Regulation[22] confers on the European Central Bank (ECB) macro-prudential supervisory tasks for credit institutions in the Member States participating in the Single Supervisory Mechanism. The Central Bank's implementation of options and discretions arising under the macro-prudential and capital buffers provisions in CRR and S.I. 158/2014 will co-exist with the ECB's own competences in those spheres. Specifically, within its area of competence, the ECB under SSM can apply stricter requirements to macro-prudential measures that are already in place at national level or could introduce one where one has not previously existed. Accordingly, there will be close cooperation between the Central Bank and the ECB on macro-prudential policy.

---

[20] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24 November 2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board, OJ L331/1.

[21] http://www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB_2014.en.pdf?b0f13f86c2fe4855025f70a23ab0a258

[22] Council Regulation (EU) No 1024/2014 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions [2013] OJ L 287 p.63.

Annex 2: Instruments in CRR/CRD IV

Table of macro-prudential instruments in CRR/CRD IV

Instrument	Legal Basis	Notifications	Reciprocity	Available from
Counter-cyclical capital buffer	Regulation 125-128 of the Regulations	Notification to ESRB on a quarterly basis	Mandatory	Jan 2016, phased in until Dec 2018
Systemic risk buffer (National power to recognise SRB rates set in other Member States)	Regulation 124 of the Regulations	Notification to COM, ESRB and EBA and the other Member States that sets the rate		
GSII/OSII buffer	Regulation 123 of the Regulations	Notification to COM, ESRB, EBA, and competent or designated authorities of the Member States. Reviewed annually, report to institution, COM, ESRB, EBA, disclose updated list of SIFIs to public		Jan 2016, phased in until Dec 2018
Article 458*	Art. 458 CRR	Subsidiarity requirement. As a rule, procedure with Commission/ Council implementing act. Notification to ESRB and EBA	Allowed	2014
*** Level of own funds, requirements for large exposures, public disclosure, capital conservation buffer, liquidity requirements, risk weights for targeting asset bubbles, intra financial sector exposures**				
Pillar II	Regulations 90-95 of the Regulations	Notification to EBA	Not explicitly provided for	2014
Risk weight for residential and commercial property	Art. 124.2 CRR-Pillar I	Prior consultation of EBA and publication by EBA of RWs / criteria	Compulsory	2014
Loss given default	Art. 164.5 CRR-Pillar I	Notification to EBA and publication by EBA of LGD values	Compulsory	2014

Note: *ESRB* refers to the European Systemic Risk Board, *EBA* refers to the European Banking Authority, *COM* refers to the European Commission.

Macro-prudential powers which are provided for under EU Law but have not been transposed into Irish law to date

Table of macro-prudential instruments in Directive 2013/36/EU (CRD IV)

Instrument	Legal basis	Notifications	Reciprocity	Available from
Systemic risk buffer	**Art. 133 CRD**	Notification to COM, ESRB, EBA, and competent or designated authorities of the Member States / third countries concerned COM opinion, implementing act or recommendation (together with ESRB recommendation) needed for buffer above certain threshold ESRB and EBA opinions for buffers exceeding a certain threshold	Allowed	Not currently available under Irish law but Government may exercise its discretion to make available at a future date.

T +353 1 224 6000 **F** +353 1 671 6561 www.centralbank.ie MacroPrudential@centralbank.ie

Banc Ceannais na hÉireann
Central Bank of Ireland

Eurosystem

Bosca PO 559, Sráid an Dáma, Baile Átha Cliath 2, Éire
PO. Box No 559, Dame Street, Dublin 2, Ireland