Ausschuss für Finanzstabilität

The macroprudential strategy of the Financial Stability Committee

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Financial Stability Committee
Bundesministerium der Finanzen
Wilhelmstraße 97
10117 Berlin
Tel.: 03018 / 682 - 0
Internet: www.afs-bund.de

Prologue

The aim of the Financial Stability Committee, or FSC (*Ausschuss für Finanzstabilität*), is to contribute to safeguarding the stability of the German financial system by shaping macroprudential policy. The idea behind macroprudential policy is to identify and mitigate systemic risk and to strengthen financial system resilience. As a preventive policy field, macroprudential policy monitors key developments throughout the financial system, covering all the areas that might be a source of risk to financial stability in Germany.

Within the European Union (EU), macroprudential policy is coordinated, in particular, via the European Systemic Risk Board (ESRB), while the primary responsibility for macroprudential policy lies at the national level. The macroprudential mandate in Germany is based on the Financial Stability Act (*Finanzstabilitätsgesetz*).

The FSC is the macroprudential authority of Germany within the meaning of the recommendation of the ESRB (ESRB/2011/3). Members of the FSC are the authorities that are relevant to financial stability and thus to macroprudential policy: the Federal Ministry of Finance, the Federal Financial Supervisory Authority (BaFin) and the Deutsche Bundesbank.

The FSC regularly analyses and assesses the risks to financial stability. Based on its assessment, the FSC considers whether macroprudential action is needed and, if so, what action needs to be taken. The composition of the FSC ensures that the authorities involved exchange the relevant information and collaborate with each other in a coordinated manner on an ongoing basis.

This strategy sets out the FSC's common understanding of the objective of making its contribution to safeguarding financial stability (Section 1) and explains the specifications and guidelines according to which the FSC fulfils its legally mandated tasks. These tasks relate to all parts of the macroprudential policy cycle. These are:

- macroprudential monitoring (Section 2);
- communication relating to financial stability risks (Section 3);
- measures to safeguard financial stability (Sections 4 and 5);
- the evaluation of macroprudential policy (Sections 4 and 5).

Macroprudential policy interacts with other policy areas. Measures taken in various policy areas are capable of supporting macroprudential policy but can also, on occasion, run counter to its objectives. Those taken in other policy areas can contribute to the build-up or mitigation of systemic risk.

Macroprudential policy is geared solely towards the aim of financial stability and not to other policy aims. However, it can communicate the potential implications of other policy measures for financial stability and, where necessary, respond suitably to potential interactions.

The macroprudential strategy is assessed by the FSC on the basis of increasing experience as well as proven analysis and decision-making procedures. This occurs as needed, but after three years at the latest. The Bundestag (lower house of the German Parliament) is informed of the results in the annual activity report submitted to it by the FSC.

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1 Safeguarding financial stability – the goal of macroprudential policy

The FSC defines financial stability as a state in which the financial system performs its economic functions and market participants constantly adapt to evolving conditions – including, if necessary, by exiting the market.

The financial system comprises the various financial intermediaries, financial markets, payment systems and market infrastructures. It performs economic functions by coordinating savings and investment, distributing risk appropriately and settling payment, securities and derivatives transactions.

A stable financial system:

- remains functional even if macroeconomic and financial conditions change;
- can absorb shocks and losses deriving from unexpected developments – especially in times of financial market stress and in phases of upheaval in the real economy – thus mitigating contagion and feedback effects;
- does not cause an economic downturn and does not excessively amplify shocks.

Dangers to financial stability are caused by the interplay between vulnerabilities that build up in the financial system, shocks and unexpected developments that affect the system, and market participants' reactions to these. Systemic risk can arise if decisions that, from the perspective of individual market participants, might appear to make sense and even potentially mitigate risk have adverse implications for the system as a whole. Individual market participants might not even be aware of such repercussions, or might regard them as negligible.

If microeconomic or macroeconomic shocks coincide with vulnerabilities in the financial system, difficulties encountered by market participants or their adjustment responses can amplify the macroeconomic impact of the original shock. In a financial system, market participants are constantly reacting to evolving conditions. They make decisions on the size and structure of their funding and their assets; they adapt their expectations to price movements, macroeconomic developments and their risk assessment; and they respond to expected or unexpected losses. Individual market participants do not necessarily take into account how their individual actions impact on the market as a whole. For instance, a negative shock can cause aggregate lending to plummet and corporate insolvencies to increase. In addition, many market participants simultaneously attempting to accumulate liquid assets and not passing on available liquidity, e.g. by lending to the real economy, is precisely when system wide liquidity shortages can ensue.

A necessity for a stable and resilient financial system is a proper microprudential supervision and regulation that is geared in particular towards the solvency and liquidity of financial corporations. On its own, however, microprudential policy is insufficient to take into account systemic developments and interdependencies in the financial system, as it focuses on individual supervised market participants. Macroprudential policy is therefore necessary as a complement to microprudential policy in order to safeguard financial stability.

2 Macroprudential monitoring: discussion and assessment of the risk situation

The FSC discusses and assesses risks to financial stability in Germany, based on analyses provided by the Bundesbank. It also relies heavily on BaFin's findings from its activities as an integrated financial supervisory authority. The Federal Ministry of Finance, the Bundesbank and BaFin propose matters relating to financial stability for discussion.

The Bundesbank analyses the systemic and macroeconomic implications of a collision of shocks and vulnerabilities as well as the resilience of the financial system. To this end, it identifies vulnerabilities and monitors them on a continuous basis.

In terms of vulnerabilities, a distinction is made between structural and cyclical aspects. Structural vulnerabilities relate to the characteristics of the financial system that foster direct or indirect contagion effects:

- the systemic importance of individual market participants that are large, complex and difficult to replace due to their critical functions or take on excessive risks ("too big to fail");
- direct or indirect interconnectedness in the financial system that fosters contagion effects ("too connected to fail");
- similarity or correlation of risks assumed by many market participants, e.g. due to similar business models ("too many to fail").

Vulnerabilities arising from similar or correlated risks assumed by many market participants can also be cyclical in nature. Cyclical vulnerabilities typically build up during upturns. For example, a long period of sound economic development can lead to risks being underestimated. This can result in an excessive increase in lending, which, in a cyclical downturn, may lead to credit defaults, a pronounced decline in lending and negative feedback loops on the real economy.

As certain vulnerabilities have both a cyclical and a structural dimension, making a conceptual distinction is only possible to a limited extent. Such vulnerabilities include, in particular, a systematic underestimation of risks or a systematic overvaluation of collateral as well as excessive maturity, currency or liquidity transformation.

Shocks can hit the financial system, or hit individual market participants and affect the system because of their size and interconnectedness. They may also stem from emergent or existing macroeconomic imbalances.

The impact of shocks on the system very much depends on the system's resilience. The better the capital and liquidity base of individual market participants, for instance, the better they can absorb shocks and the smaller the spill-over effects for other institutions. In addition, sufficient resilience can prevent shocks from being amplified by the financial system. These kind of feedback loops can emerge, for example, if many banks restrict their lending to the real economy. Sufficient resilience is a prerequisite for the financial system to perform its functions even during periods of stress.

The dynamic nature of the financial system means that continuous critical reflection on the methods and areas of analysis is required. To this end, research findings and insights from relevant international bodies are taken into account. The FSC regularly reviews the existing framework.

3 Communication

Macroprudential policy is highly preventive in nature and acts to a large extent through the expectations and the behaviour of many financial market participants. Effective macroprudential policy therefore requires appropriate external communication. The FSC communicates regularly and in a transparent manner. External communication has three purposes:

- Accountability and public information: The FSC regularly informs the public about developments with a bearing on financial stability and about its activities, and it explains its assessment of financial stability. This communication mainly comes in the form of its annual report to the Bundestag.
- Formation of expectations through early risk communication: The FSC uses various forms of public relations to provide the public with ad hoc information about its assessment of the risk situation or to raise awareness of issues relating to financial stability. The aim of communication with the public is to facilitate the formation of expectations among market participants and other stakeholders on issues relating to financial stability and on the FSC's macroprudential policy stance, as well as to support macroprudential measures.
- Communication in the event of a build-up of systemic risk: When a build-up of systemic risk has been identified, the FSC uses suitable forms of communication as a preventive measure to reduce the probability and potential impact of a financial crisis that has not yet materialised.

The FSC's activities and actions mainly concern periods in which there is a build-up of risks to financial stability. In the event of a severe financial crisis, it is generally not the role of the FSC to respond to said crisis with its own measures. Nevertheless, as part of its regular tasks, it continuously assesses the macroprudential risk situation even in the event of a financial crisis that has already materialised. The institutional structures of the FSC allow the authorities represented in it to coordinate quickly and effectively and to reach agreements with each other at an early stage. This relates, in particular, to assessments of the effects of measures taken in crisis situations to mitigate the impact of an economic shock on financial stability.

The FSC's external communication serves to support the effectiveness of macroprudential policy. To this end, the aim is for the FSC to be perceived as an independent body by the public and for communication by the authorities represented in it to be as coordinated and consistent as possible. In addition to its annual report, the FSC largely communicates with the public via press briefings and via its website.

4 The FSC's macroprudential measures and evaluation

Financial crises have high economic and social costs: they cause economic output to drop while driving up unemployment and public debt. Given the social costs that financial crises have, the FSC acts in a forward-looking and proportionate manner. Forward-looking action is needed, as macroprudential policy has a preventive effect. It must identify and limit systemic risks as early as possible amidst uncertainty and strengthen the financial system's resilience before the risks materialise.

The FSC's decision-making process on the use of macroprudential measures follows the macroprudential policy cycle. The FSC uses its risk analysis to identify potential risks to financial stability. Building on this, it decides whether and in what form action is necessary. This decision is also based on analyses that assess the impact of policy options before they are introduced. Once the measures have been implemented, the FSC evaluates their effectiveness and identifies where adjustments might be needed. Any lessons learned are taken into consideration when designing future measures.

In addition to the forms of communication described in Section 3, the FSC has at its disposal two macroprudential measures which are enshrined in the Financial Stability Act: the option of issuing warnings and recommendations. These measures can be addressed to the Federal Government, BaFin or other German public sector authorities. The FSC uses these measures to shape macroprudential policy in a preventative manner and thus to achieve its objective. Its warnings and recommendations are generally published. The FSC therefore takes into account the signals it would send to the public in the process and whether publication itself could pose a threat to financial stability. If this is the case, warnings or recommendations are not published.

Warnings and recommendations have different objectives:

- The FSC uses warnings about identified risks in its risk communication. They are issued if the Committee wishes to make addressees aware of a looming threat to financial stability and if the information content of the warning can help safeguard financial stability. Warnings have a coordination function and are intended to encourage addressees to take the identified risks and dangers into account in their decisions.
- In its recommendations, the FSC points to looming threats to financial stability and outlines concrete options for action which it considers necessary, suitable and appropriate in order to counter the threat. Recommendations may include, in particular, macroprudential measures that other domestic public authorities could take to help safeguard financial stability (Section 5). The addressee of a recommendation must inform the FSC of the way in which it is implementing the recommended measures or justify why it intends to deviate from the recommendation. Recommendations may also include proposals for changes to the regulatory framework. The Federal Ministry of Finance can use the Federal Government's right of initiative to instigate legal implementation in a timely manner.

The FSC reviews and assesses the implementation of recommendations by the addressees or the justification as to why an addressee is deviating from the recommendation. It evaluates the effectiveness of macroprudential measures ex post and thus assesses whether, in its view, the measures need to be adapted in terms of their nature or scope. This is done based on an assessment by the Bundesbank.[1] Such assessments of public recommendations are generally published.

The evaluation of macroprudential measures is key, as macroprudential policy is preventive in nature and macroprudential measures are taken amidst uncertainty. There is uncertainty, amongst other things, as to how effective the measures are and about the future macroeconomic developments that would arise with and without measures. The evaluation of measures is designed to give a better understanding of their impact on the underlying risks and focuses on the macroeconomic impact of macroprudential measures, possible second-round and distributional effects and changes in the resilience of the financial system.

[1] The implementation by the addressee is assessed in line with the ESRB's approach (see revised Handbook on the follow-up to ESRB recommendations, April 2016; see also the schema for assessing the FSC recommendation on the regulation of residential real estate lending, March 2016).

5 Macroprudential measures taken by the competent authorities

If the FSC's risk assessment concludes that the financial system may not be sufficiently resilient in light of growing vulnerabilities, it recommends that the competent authorities take targeted macroprudential measures. This does not release these authorities from their obligation to conduct their own review of whether the prerequisites, particularly that of proportionality, for implementing the recommendation are met (Section 4).

In order to provide evidence of proportionality, the FSC's recommendations always include a risk analysis, a risk assessment and an ex ante impact assessment. In addition, they contain a specific measure and a proposal for its particular design, as well as evidence that it is necessary, suitable and adequate. The FSC can arrange for third parties to be consulted in order to develop effective and efficient policy options.

The recommended measures are aimed at either increasing the resilience of the financial system to identified vulnerabilities or reducing identified systemic risks in the financial system. The former type of measures comprises, in particular, macroprudential tools for raising capital requirements. If individual market participants incur losses, capital buffers help to cushion their impact and to minimise contagion and feedback loops. Preventive macroprudential policy involves safeguarding financial stability even in phases of stress and counteracting systemic risk where market participants exhibit crisis-intensifying behaviour, not least by ensuring that macroprudential capital buffers are built up in good times so that they can be released in the event of a macroeconomic shock. Measures to address the identified risks directly include the existing tools for regulating lending for the construction and purchase of residential real estate. These measures usually have a more direct steering effect than those affecting general capital adequacy.

From the perspective of the FSC the use of macroprudential measures by the competent authorities should be based on an overall assessment of risks. Their application should, as a general rule, follow the principle of rules-based discretion, which combines a rules-based component with a discretionary component. While the rules-based component is founded on one or more reference indicators, a number of additional indicators and analyses feed into the discretionary assessment. As their forecasts are subject to uncertainty, this gives the competent authorities the necessary leeway to respond flexibly in complex and dynamic situations while keeping macroprudential measures sufficiently transparent.

The FSC can task the Bundesbank and BaFin with developing the methodological approaches and sets of indicators on which to base rules-based discretion, and with performing more detailed analyses. Buffer guides, which have been derived for main indicators using such frameworks, and corresponding analyses are presented regularly to the FSC. The frameworks are continually adjusted to take account of methodological and legal developments and are discussed where necessary within the FSC.[1]

[1] The procedure for identifying other systemically important institutions (O-SIIs) is one example of the methodology for addressing structural vulnerabilities. One example of the methodology for addressing cyclical vulnerabilities is the method used to calculate the countercyclical capital buffer. Another is the response to warnings and recommendations issued by the ESRB or the recognition of measures implemented by other EEA countries (the Banking Act (*Kreditwesengesetz*) provides the legal basis for the reciprocity of measures under Article 458 of the CRR (see Section 48t(4) of the Banking Act)).