



MACRO-PRUDENTIAL POLICY STRATEGY

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1. Introduction

Banco de Portugal, as the designated national authority for macro-prudential policy, is responsible for defining the strategy for the implementation of this policy. The legal and institutional arrangements of macro-prudential policy are defined in the Organic Law of Banco de Portugal, which attributes to this institution the responsibility of defining and conducting macro-prudential policy, “*in particular by identifying, monitoring and assessing systemic risk, and by proposing and adopting measures to prevent, mitigate or reduce such risks in order to strengthen the resilience of the financial sector*”. Its statutory powers and the objective of strengthening the resilience of the financial sector, confer upon Banco de Portugal the possibility to issue orders, recommendations and warnings that may be deemed necessary to fulfil its mandate.

This document presents the strategy defined by Banco de Portugal to guide the implementation of macro-prudential policy, thus complying with the European Systemic Risk Board Recommendation on intermediate objectives and instruments of macro-prudential policy (ESRB/2013/1). This strategy encompasses, in addition to the selection of intermediate objectives and instruments, the decision-making process (including the monitoring of potential sources of risks), the activation of policy instruments, the assessment and evaluation of policy impact and the communication of risk assessment and policy actions.

This document is structured as follows: section 2 describes the macro-prudential policy objectives and instruments available for policy implementation; section 3 focuses on risk assessment, policy implementation and evaluation; section 4 describes the institutional framework and section 5 addresses the communication on risk assessment and policy.

2. Objectives and instruments of macro-prudential policy

In December 2014, in accordance with the above mentioned ESRB Recommendation, Banco de Portugal identified the main intermediate objectives and instruments of its macro-prudential policy (i.e. the macro-prudential toolkit).¹

The ultimate objective of the macro-prudential policy is to contribute to the safeguarding of financial stability, by strengthening the resilience of the financial sector and preventing systemic risk. Taking into account the variety of factors that may lead to the build-up of systemic risk, the ultimate objective of this policy is too wide and difficult to assess. In this context, the definition of intermediate objectives – more directly related to the mitigation of the various sources of systemic risk and the appropriate policy instruments to prevent them –, make macro-prudential policy more operational and transparent. By monitoring the intermediate objectives it is also possible to better assess progress against the ultimate objective of macro-prudential policy and to more easily address the origin of the risk factors.

The intermediate objectives adopted by Banco de Portugal to guide macro-prudential policy were identified according to their relevance in the context of the Portuguese banking system. Although

¹ See <https://www.bportugal.pt/en-US/EstabilidadeFinanceira/Documents/Macro-prudential%20policy%20in%20Portugal.pdf>

the scope of macro-prudential policy covers the financial system as a whole, the instruments that have been included in the macro-prudential toolkit so far only target the banking sector. This is justified by the greater importance of this sector in the domestic financial system and by the fact that the appropriate instruments to mitigate systemic risk originating in the insurance and pension funds sectors or in the securities market are still being discussed at international level, with the participation of Banco de Portugal. The instruments have been selected according to their suitability to mitigate the main risks which could undermine the achievement of the intermediate objectives. This selection procedure also reflects the balance between, on the one hand, ensuring an adequate coverage of risks and, on the other, avoiding unnecessary overlaps caused by having multiple instruments to address the same goal. As such, at least one instrument was selected to achieve each of the four identified intermediate objectives and, only when sufficiently differentiated, more than one instrument was selected for a given intermediate objective.

Considering that macro-prudential policy is quite recent, in particular at European level, the intermediate objectives and instruments selected at national level are expected to be revised and updated over time. Moreover, the list of selected instruments should not be viewed as exhaustive, but indicative of the instruments that were given priority by Banco de Portugal in the mitigation of risks, and whose conditions for implementation at national level will be further developed.

The following table summarises the links between the intermediate objectives of Banco de Portugal macro-prudential policy and the instruments selected to mitigate them.

Table 1: Link between intermediate objectives and macro-prudential policy instruments

Intermediate objectives	Macro-prudential policy instrument
Mitigate and prevent excessive credit growth and leverage	Countercyclical capital buffer (CCB) Sectoral capital requirements Limits on the loan-to-value ratio (LTV) Limits on the loan-to-income ratio (LTI) / debt service-to-income ratio (DSTI)
Mitigate and prevent excessive maturity mismatch and market illiquidity	Loan-to-deposit ratio
Limit direct and indirect exposure concentrations	Systemic risk buffer (SRB) Large exposure restriction
Limit incentives for excessive risk-taking by systemically important institutions	Capital buffer for other systemically important institutions (O-SII buffer)

3. Risk assessment, policy implementation and evaluation

A key element of macro-prudential policy is the regular identification and assessment of market failures and sources of systemic risk, which may impair financial stability and generate negative spillovers to the real economy.

Risk assessment

More specifically, the safeguard of financial stability is regularly assessed through a monitoring framework based on the four intermediate objectives adopted by Banco de Portugal. The evolution of systemic risk is evaluated at a fairly aggregated level over time, considering a comprehensive set of indicators covering all sectors of the financial system as well as their counterparties. Special attention is paid to the banking sector given its importance in the Portuguese financial system. In tandem with the analysis at the aggregate level, an assessment is made using disaggregated data, if deemed relevant. In addition to the use of plain-vanilla indicators, the risk assessment framework also encompasses composite indicators and analytical models, making it possible to unfold the level of interconnectedness within the financial system and with the real economy. The analysis of cross-border interconnectedness also requires the appraisal of non-domestic risks, which are put into perspective in the context of domestic developments. Finally, qualitative information and expert judgement are also weighed in the risk assessment process.

The whole risk assessment framework is likely to be periodically revised and enhanced as the risks' nature may evolve through time, analytical tools and models may be further developed and more experience is acquired in this particular area.

The regular risk monitoring framework allows Banco de Portugal to identify and assess the potential sources of systemic risk that may hinder the attainment of the intermediate objectives of macro-prudential policy. Once the potential risks to financial stability are identified, Banco de Portugal shall evaluate whether there is a case for adopting a specific macro-prudential measure. In this context, the interactions between macro-prudential and other policy areas, such as monetary, fiscal and micro-prudential policies, must be taken into account.

Policy implementation

The design of a macro-prudential policy measure entails the selection of the macro-prudential instrument(s) most suited to address the source of systemic risk identified. Although the already established link between intermediate objectives and instruments may guide the instruments selection, this task is not a trivial one, in the sense that it should take into account general principles such as: (i) the suitability of a particular instrument (or a mix of instruments) in meeting the macro-prudential policy intermediate objective, (ii) the proportionality between the potential costs associated with the instrument and the benefits associated with the achievement of the intended objectives, and (iii) the simplicity and transparency of the instruments.

In practical terms, the selection of instruments encompasses analysis on the (i) instruments' transmission mechanisms, (ii) potential interaction with other policies (such as micro-prudential

and monetary), (iii) cost / benefit analysis, (iv) assessment of potential regulatory arbitrage and leakages, and (v) cross-border effects and reciprocity.

Understanding the transmission channels of the instrument or pool of instruments under scrutiny is of most importance to define a macro-prudential policy stance. In fact, the analysis of the propagation channels of macro-prudential policy instruments is essential to understand their impact on the financial cycle and on the real economy. Some instruments are system-wide, while others are sector or institution-specific. They can also address cyclical systemic risk (i.e., with a direct impact on the upswing and downswing of the financial cycle) or structural systemic risk (i.e., related with the resilience of financial institutions and their capacity to absorb losses underlying the failure of a systemically important financial institution).

The analysis of the transmission channels is also important given the aforementioned interaction between macro-prudential policy and other policies, such as micro-prudential policy (e.g., macro-prudential buffers interaction with Pillar 2 measures), monetary policy (e.g., macro-prudential measures may impact the monetary policy transmission mechanisms), and resolution policy (e.g., macro-prudential buffers interaction with minimum requirement for own funds and eligible liabilities requirements (MREL)). Against this background, close cooperation between relevant authorities shall be ensured.

The comprehension of the instruments' transmission mechanisms is also needed to evaluate the benefits and costs of imposing a macro-prudential measure. A desired macro-prudential policy stance shall maximize the benefits, while minimizing the costs to the society. A practicable approach to this cost / benefit analysis encompasses assessing the effectiveness of the instruments in relation to the desired objective, and the social costs they may give rise to by imposing restrictions on financial institutions and activities.

In this assessment, it should be acknowledged that the effectiveness of macro-prudential policy may be hindered by different types of leakages involving (i) institutions outside the scope of the instrument; (ii) non-regulated entities; and (iii) cross-border lending. Due to the fact that the banking sector might be facing higher capital requirements, credit granted to the private non-financial sector may be replaced with credit from non-regulated entities or by the issuance of other financial instruments.

Furthermore, branches of the European Union (EU) that operate in the country that adopts a macro-prudential measure will not be required to comply with the macro-prudential instruments specially targeting certain risk exposures. Thus, EU branches may actually contribute to the amplification of the relevant macro-prudential risks in the activating country, hindering the macro-prudential policy effectiveness. In this context, coordination across EU Member States is key for the effectiveness of macro-prudential measures. Taking into account the potential adverse cross-border impact of national macro-prudential instruments, and with the purpose of ensuring the effectiveness and efficiency of these measures, Banco de Portugal shall conduct regular analysis on the identification and evaluation of each macro-prudential measure spillovers to other countries. If this analysis shows that the cross-border implications of a macro-prudential policy measure may be significant, reciprocity considerations shall be considered. While there are macro-prudential measures which are already subject to mandatory reciprocity by other countries, an assessment on the need of a coordinated response among countries on the form of

reciprocity should be conducted for the measures that are not subject to the same legal requirement.

Once the choice of the instrument (or a set of instruments) is made, the final calibration shall be conducted, based both on quantitative and qualitative assessments of the level of systemic risk, that is, based both on analytical foundations and on judgement (guided discretion) in order to cover new and evolving types of risk.

Finally, the legal form of a macro-prudential decision shall be determined on the basis of an analysis of the most effective legal tools to address the systemic risk under evaluation (i.e. whether it should take the legal form of orders, recommendations or warnings).

Evaluation

Evaluating ex-post the impact of macro-prudential policy is important to enhance its credibility and to assess the efficacy and efficiency of the instruments used. This evaluation should consist of analysing the extent to which the objective was achieved and which other variables were affected by the policy (either intended or unintended effects – costs of policy decisions). In addition, it should include an assessment of whether other factors could have contributed to these outcomes (counterfactual) and whether other policies or instruments could have produced the same outcomes at lower costs (efficiency).

This exercise will provide more information concerning the transmission mechanism of policy decisions to the financial system and the real economy, thereby allowing a more precise calibration of instruments in the future.

4. Institutional framework and coordination mechanisms

The role of Banco de Portugal as macro-prudential authority shall be understood in the context of the institutional arrangements defined at the national and EU levels for the purpose of promoting financial stability.

Pursuant to the national legal and institutional framework, Banco de Portugal is responsible for promoting the stability of the financial system, also acting as lender of last resort (within the framework of the European System of Central Banks), regulator and supervisor, payment system overseer, and national resolution authority (since 2012).

Pursuant to its Organic Law, Article 54, Banco de Portugal is accountable to the Portuguese Parliament and its annual report must be approved by the Minister of Finance.

Banco de Portugal, as set out in its Organic Law, shall also establish mechanisms for cooperation with other relevant public authorities and financial supervisors. Three different and independent authorities are responsible for supervising the Portuguese financial system: Banco de Portugal, which is both the macro-prudential authority and the micro-prudential supervisor, the Securities Market Commission (*Comissão do Mercado de Valores Mobiliários – CMVM*), which is the supervisor and regulator of securities markets (and markets for other financial instruments) as well as of the activity of those who operate in such markets, and the Insurance and Pension Funds

Supervisory Authority (*Autoridade de Supervisão de Seguros e Fundos de Pensões - ASF*), which is responsible for supervising and regulating the insurance and pension funds sector.

In line with the formal mandate of Banco de Portugal as macro-prudential authority, the legal framework assigns the National Council of Financial Supervisors (*Conselho Nacional de Supervisores Financeiros - CNSF*) an advisory role to Banco de Portugal on macro-prudential matters.

Cooperation among the financial supervisors occurs under the auspices of the CNSF, in which the three national financial supervisors are represented. The CNSF is permanently chaired by the Governor of Banco de Portugal and is composed of permanent representatives from the three supervisory authorities, specifically the member of the Board of Directors of Banco de Portugal responsible for supervising credit institutions and financial companies and the presidents of ASF and CMVM. Furthermore, when acting under its macro-prudential advisory role, a representative from the Finance Minister and also the member of the Board of Directors of Banco de Portugal responsible for macro-prudential policy will participate in CNSF's meetings as observers. Other public or private entities may be invited to participate in the CNSF's meetings.

The CNSF has the responsibility to advise Banco de Portugal in the context of defining and conducting macro-prudential policy. The CNSF should support Banco de Portugal notably by providing an encompassing overview of the risks to the whole Portuguese financial sector and by analysing and discussing specific draft macro-prudential measures. To this purpose, the CNSF is, in particular, responsible for: (i) helping to identify, monitor and assess risks to the stability of the financial system and (ii) analysing specific macro-prudential policy proposals, with the aim of mitigating or reducing systemic risk, in order to reinforce the stability of the financial system. Nonetheless, the ultimate decision as regards defining and implementing macro-prudential policy is the responsibility of Banco de Portugal.

At the EU level, there are also pre-established institutional arrangements for macro-prudential policy. There are specific procedures in what regards the cooperation with the European Central Bank in Single Supervisory Mechanism composition (ECB-SSM), with respect to macro-prudential tasks and tools conferred to the ECB-SSM.² In accordance with these cooperation procedures, Banco de Portugal shall notify the intention to apply macro-prudential tools to the ECB prior to taking a final decision. In the case the ECB objects the intended measure it shall state its reasons and Banco de Portugal shall consider them prior to proceeding with the decision. If deemed necessary, the ECB-SSM may apply higher requirements for capital buffers or stricter measures than those applied by national competent authorities in addressing systemic risk.

Banco de Portugal shall also collaborate with the ESRB, which is responsible for the macro-prudential oversight and the prevention and mitigation of the systemic risk to the EU financial system. The ESRB may issue warnings and recommendations that are subject to a 'comply or explain' mechanism, i.e., in the case Banco de Portugal does not intend to comply with those warnings and recommendations, it must inform the ESRB and state the reasons for non-compliance.

² Pursuant to Article 5 of the Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring macro-prudential tasks on the ECB (also known as SSM Regulation).

Furthermore, Banco de Portugal is also required to comply with the European Banking Authority (EBA) regulation. Among other attributions, this institution has the responsibility to assess risks and vulnerabilities in the EU banking sector and to perform these tasks, the EBA can issue regulatory documents such as binding Technical Standards, Guidelines and Recommendations, to which Banco de Portugal shall comply with, when applicable. Those Guidelines and Recommendations are also subject to the 'comply or explain' principle.

Finally, depending on the macro-prudential measure at stake, Banco de Portugal may have to notify the European Commission and, in specific cases, shall take into consideration the opinion of the European Commission before adopting the measures in question.

5. Communication

Banco de Portugal's communication framework on systemic risk assessment and macro-prudential policy follows generally agreed principles of communication. In particular, Banco de Portugal should be as clear, concise and transparent as possible in its communication to the public. Banco de Portugal may also decide to issue confidential warnings or recommendations to specific authorities or institutions, which are made public, when sensitive information is not at stake.

In addition, financial stability and macro-prudential policy publications of Banco de Portugal are designed to be consistent over time and are in general published according to a pre-defined agenda. Banco de Portugal also seeks to achieve coordination across all the authorities involved in the decision-making process when issuing a policy decision or a risk assessment. Furthermore, it acts to ensure that announcements of macro-prudential measures are timely released to prevent the build-up of systemic risk, while providing targeted institutions sufficient time to adapt to new requirements.

The main purpose of Banco de Portugal's communication on risk assessment and macro-prudential policy is to inform the public and targeted institutions about the identified risks to financial stability and the implementation of macro-prudential measures.

Specifically, Banco de Portugal's views on financial stability and systemic risk assessment are communicated to the public mainly via the Financial Stability Report. This publication assesses emerging or existing risks in the Portuguese markets and financial system, entailing the identification of adverse shocks and the likelihood of their materialization, as well as an evaluation of the consequences of such shocks for the stability of the financial system.

The announcement of policy measures are generally accompanied by the disclosure of underlying analyses, information on the operational features of activated instruments and the link with the associated intermediate objectives. Banco de Portugal has established a dedicated webpage, with an overview of the current macro-prudential toolkit and overall capital requirements, as well as information on the underlying legal framework³. It has also established specifically tailored

³ See www.bportugal.pt/en-US/EstabilidadeFinanceira/MedidasMacroprudenciais/Pages/MedidasMacroprudenciais.aspx

information for each implemented measure, explaining the purposes of the measure, current decisions and background analyses, and displaying the links to methodological documents and instrument-specific legal frameworks (e.g., ESRB Recommendations and EBA Guidelines). These dedicated webpages are updated regularly (e.g., when a new decision is taken). Information on the tentative date for the disclosure of the next decision (if applicable) and contacts for further clarifications are also provided.

Based on the aforementioned objectives and principles, Banco de Portugal expects that economic and financial agents become better informed about systemic risk, therefore being able to make better informed decisions. Additionally, effective communication about macro-prudential policy promotes the accountability of Banco de Portugal in the exercise of its duties as macro-prudential authority.