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Macroprudential reciprocity framework in the EU - considerations for non-EU countries[1, 2]

Abstract (Teaser): In the process of implementation of macroprudential instruments in EU candidate and potential candidate countries in the Western Balkans, where banking systems are in significant (around 65%) ownership of the EU headquartered banks, it is noticed that EU does not regulate reciprocity of the most macroprudential instruments adopted in third countries. It means that the EU banks are not obliged to reciprocate local macroprudential policy measures which gives room for regulatory arbitrage. Taking into consideration the abovementioned, the main goal of this paper is to analyse EU macroprudential regulatory framework and to assess the position of macroprudential measures of non-EU countries - EU candidate and potential candidate countries - within that framework. The main result of this paper is a proposal for the permanent regulated macroprudential reciprocity framework between the EU countries and EU candidate and potential candidate countries, based on the conducted analysis.

Key words: reciprocity, macroprudential instruments, financial stability, EU candidate and potential candidate countries.

[A] Introduction

After the beginning of the 2008 World Economic Crisis, which started with the bankruptcy of Lehman Brothers in September 2008, both on international level and on local level, a lot of efforts have been invested in the development of the missing area of public policy - macroprudential policy. This led to the establishment of dedicated authorities in charge of macroprudential policy both at the state and supranational level, or to entrusting to already existing bodies to conduct this policy, most often to central banks. In parallel with the establishment of these bodies, the macroprudential toolkit is developed both within Basel III (Capital Conservation Buffer, Countercyclical Capital Buffer, Capital Buffer for Systemically Important Institutions) and by identifying other instruments. In this gradual development, at the very beginning, due to deep financial integration, the need for regional and international coordination of macroprudential instruments and the avoidance of regulatory arbitrage was identified.

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[2] The opinions presented in this paper are those of the author and do not reflect the official viewpoint of the National Bank of Serbia.

Namely, if there is no reciprocity of macroprudential measures, and if cross-border lending, or lending through branches has a high share in total loans in a particular country, that situation could lead to avoidance of the application of restrictive macroprudential measures by increasing cross-border loans and lending through branches (IMF 2013). In this way, the local macroprudential regulator, despite the fact that there is a macroprudential authority in the country and a legal basis for the application of macroprudential instruments, could only partially control the accumulation of systemic risk. Considering that macroprudential policy is a new area of public policy, at its very beginning, competent authorities have to undertake necessary activities in order to ensure reciprocity of macroprudential measures and, in that way, to rise public trust in the effectiveness of this policy.

In order to solve this problem at EU level, at the end of 2015, the European Systemic Risk Board put in place a reciprocity framework of macroprudential policy measures.[3] However, the mentioned reciprocity framework only regulates the reciprocity of macroprudential measures between EU Member States, but not between Member States and third countries. Thus, candidate countries for EU membership and potential candidate countries are particularly affected since even though they are not EU members, their financial systems are largely interconnected with the EU financial system. Although coordination of regulatory policies between emerging Europe and EU has been functioning within Vienna Initiative to the certain extent, the need for permanent and regulated solution cannot be denied. Therefore, it is important to develop a macroprudential reciprocity framework between EU member states and third countries - especially EU candidate countries and potential candidate countries. The aim of this paper is to provide a proposal for the establishment of the macroprudential reciprocity framework between EU and its potential members.

[A] Importance of the macroprudential reciprocity for third countries (especially EU candidate and potential candidate countries) – the case of Serbia

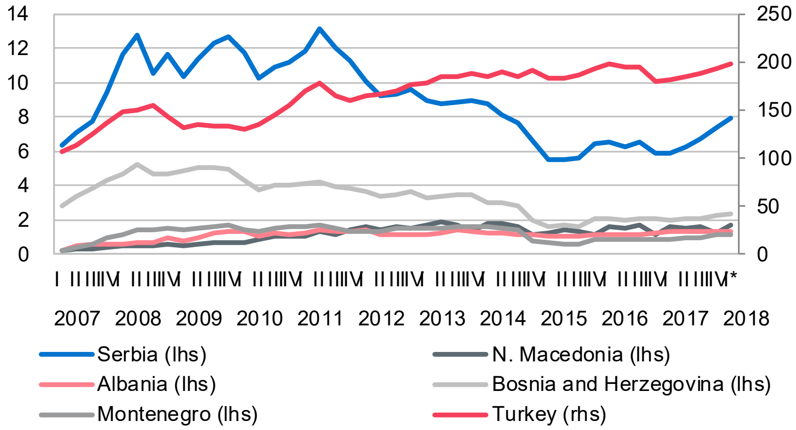
The obligation of reciprocity of national macro-prudential measures is important for the effectiveness of each country's macro-prudential policy, and in particular countries which financial and banking systems are highly integrated into the regional or international financial system.

The higher level of financial integration exists, the higher need for the reciprocity there is. On the European soil, concerning the degree of financial integration, beside EU member counties, the special attention should be given to EU candidate countries and potential candidate countries from Western Balkans (Albania, Bosnia and Herzegovina, Northern Macedonia, Montenegro and Serbia) since financial systems of these countries are largely interconnected with foreign financial systems, and in particular with the EU financial system. The data show that between 70% and 90% of the assets of banking sector in the Western Balkans countries relate to foreign banks, of which about 65 pp refers to EU-based banks (Gächter et al., 2017). Chart 1. shows the movement of cross-border exposure of BIS

[3] https://www.esrb.europa.eu/national_policy/reciprocation/html/index.en.html

reporting banks to the above-mentioned countries and Turkey. This chart displays that, while the exposures from the third quarter of 2008 (Lehman Bankruptcy) to Bosnia and Herzegovina, Montenegro and Serbia have decreased, the exposures to Albania, Northern Macedonia and Turkey have increased despite the post crisis deleveraging of European banks.

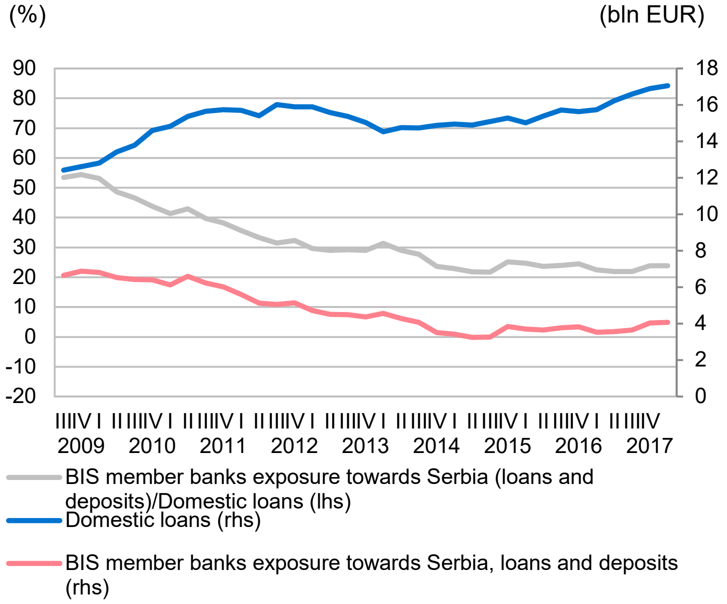
Chart 1. BIS reporting banks' gross exposure towards Western Balkans and Turkey



*Latest data available.
Source: Bank for International Settlements.

Regarding the importance of cross-border loans for the economies of Western Balkans countries, we can take the example of Serbia as given in Chart 2. This graph illustrates that cross-border loans and deposits of BIS reporting banks at the end of 2009 amounted to as much as 55% of domestic loans and in the first quarter of 2018, these loans and deposits amounted to about 24% of domestic loans. The observed data point to two facts simultaneously – first, that cross-border loans in the post-crisis period are significantly reduced in relation to domestic loans due to the deleveraging of foreign banks operating in Serbia, and second, much more significant fact, that the historically highest possible level of cross-border loans was very substantial and amounted to 55% of domestic loans. In the absence of reciprocity of domestic macroprudential measures, this level represents the historical maximum volume of loans to which macro-prudential measures, adopted by the local macroprudential regulator (other than Countercyclical Capital Buffer - CCyB), might not be completely effective.

Chart 2. Ratio of BIS reporting banks exposure towards Serbia and domestic loans



Source: NBS and Bank for International Settlements.

In Table 1. Timeline of Macroprudential instruments in Serbia, the overview of historically applied macroprudential instruments (active and inactive instruments) that refer to both dimensions of systemic risk - cyclical and structural, is given. This table also indicates whether the reciprocity of each of the applied instrument is necessary.

Table 1. Timeline of Macroprudential instruments in Serbia

Year	Macroprudential instrument	Prevailing Systemic risk dimension	Need for reciprocity
2004 – 2012	**DTI (debt-to-income) limit** *(30%), with its value subsequently changed several times and finally revoked in December 2012*	**Cyclical**	**Yes**
2004 – 2011	**Loan down payment requirement for physical persons** – *if the physical person to whom a loan is approved makes a down payment or a deposit of less than 20% of the loan amount, such receivable is classified by the bank under V category, from 2006 in D category (100% loan loss reserves); in 2008 the down payment was increased to 30% of the loan amount and exception for local currency loans was introduced*	**Cyclical**	**Yes**
2005 –	**Higher Reserve Requirement on FX base** *relative to the local currency base (RSD 20%, FX 26%) – to reduce the share of FX and FX-indexed loans (now RSD 5%, FX 20% for up to two-year liabilities and RSD 0%, FX 13% for liabilities over two years);*	**Structural**	**Yes**
2006 –	**The ratio of net open foreign currency position to capital** *was reduced from 20% to 10%; in 2008 it was raised to the current level of 20%;*	**Structural**	**Yes**
2006 – 2011	**Higher Risk Weights (125%) for FX unhedged receivables** *amounting to at least RSD 10 million*	**Structural**	**Yes**
2006 – 2009	**Limit of lending to households relative to the capital of 200%***; as of 2007 this percentage was decreased to 150%, – this limit was abolished in June 2009*	**Cyclical**	**Yes**
2007 – 2009	**Countercyclical Reserves for general banking risks** *in the case of balance sheet growth above 15% year-on-year*	**Cyclical**	**Yes**
2011 –	**FX-indexed loans for individuals were banned***, except euro-indexed*	**Structural**	**Yes**
2011 –	**80% LTV (loan-to-value) ratio for FX-indexed housing loans,** *exceptionally 90%*	**Structural**	**Yes**
2011 –	**Mandatory 30% down payment for all FX or FX-indexed loans borrowed by the physical persons**	**Structural**	**Yes**
2017 –	**Capital conservation buffer** – *2.5% of RWA*	**Cyclical**	**No**
2017 –	**Countercyclical capital buffer** – *rate of 0% for the exposures in Republic of Serbia*	**Cyclical**	**Yes**
2017 –	**Systemic risk buffer***, 3% of FX lending to households and corporates for all banks with the level of euroization above 10%*	**Structural**	**Yes**
2017 –	**Capital buffer for systemically important banks***, nine banks that are identified as systemically important are obliged to maintain additional capital buffer of 1-2% of RWA*	**Structural**	**No**

Source: Author.

[A] Reciprocity framework in the EU

In December 2015, the ESRB adopted a recommendation on the assessment of cross-border effects and voluntary reciprocity of macroprudential policy measures (ESRB/2015/2), which was amended by the ESRB recommendation (ESRB/2017/4) in October 2017. As follows, a framework of reciprocity of macroprudential measures has been established between the EU Member States. In accordance with stated recommendations, this framework consists of two phases. The first phase relates to the assessment of cross-border effects of macroprudential policy measures, and the second phase to the reciprocity of these measures.

In the first phase, the relevant activating authorities are recommended to assess, before their adoption, the cross-border effects of the implementation of their own macroprudential policy measures. After conducted analysis and adoption of the measure, the second phase starts, where the relevant macroprudential bodies are recommended to notify the ESRB of macroprudential policy measures as soon as they are adopted, and no later than two weeks after their adoption.

After the notification, the ESRB would recommend to national macroprudential authorities to implement reciprocation measures in question by amending the ESRB recommendation ESRB/2015/2. National macroprudential authorities are obliged (comply or explain principle) to implement the same measure, or if the same measure is not available they are recommended to reciprocate, following consultation with the ESRB, by adopting a macroprudential measure available in its jurisdiction that has the most equivalent effect.

In addition to the voluntary reciprocity of macro-prudential measures, there is also a mandatory reciprocity in the EU of the rate of CCyB, and in respect of real estate exposures measures (ESRB 2017).

As it can be concluded, voluntary reciprocity is a rule within the EU, while mandatory reciprocity is only an exception for a very small number of measures.

[A] Proposal for the reciprocity framework between the EU member states and the EU candidate and potential candidate countries

Based on the analysis carried out, it can be concluded that the level of financial integration determines the need for the reciprocity of national macroprudential measures. The higher the level of integration is, the more significant need for the reciprocity exists. This is particularly evident in the case of EU candidate countries and potential candidates whose financial systems are deeply integrated with the EU's financial system but which do not yet have a permanent regulated framework for reciprocity of macro-prudential measures with the EU at the moment. This means that there is a room for regulatory arbitrage of national macroprudential measures whose effects could be evaded by increasing cross-

border lending directly from EU member states. In order to prevent this from happening, these countries have capital control measures, however, most of these countries have given up those measures, since in the stabilization and accession process with the EU it is necessary to remove obstacles for cross-border lending. Therefore, EU candidate countries and potential candidate countries are in specific vicious circle where they cannot impose capital controls in order to be in line with EU regulations, and on the other hand they might be in problem to ensure the reciprocity of their macroprudential instruments. This problem is temporarily bypassed by the success of Vienna initiative, but in legal terms it cannot be considered as a permanent solution.

A solution to this issue should be sought in developing a reciprocity framework between EU candidate countries and potential candidates and EU member states. While it is possible to take into account bilateral and multilateral solutions, they are inferior compared to the use of opportunities provided by the macroprudential legal framework and the reciprocity framework already developed at the EU level. Specifically, the ESRB has developed a reciprocity framework at EU level, but it is only applied to EU member states. Based on this framework it would be possible to set the basic elements of the proposal for a framework for macroprudential reciprocity between EU member states and the EU candidate and potential candidate countries. This framework could include the following elements:

- It should be based on the recommendations of the ESRB addressed to the competent macro-prudential authorities of the Member States that would relate only to the reciprocity of macro-prudential measures between EU Member States and the EU candidate and potential candidate countries;
- The requirement for the application of reciprocity should be the existence of a parallel framework in the EU candidate and potential candidate countries that would allow the reciprocity of macroprudential measures of EU member states in the EU candidate and potential candidate countries;
- The elements of the reciprocity framework should be similar to the framework applied between EU member states and voluntary reciprocity should be a rule, while the mandatory reciprocity should be an exception;
- The procedure for achieving reciprocity should consist of two phases; the first phase would relate to the analysis of cross-border effects of macroprudential measures by the state that intends to adopt the appropriate measure, while the second phase would refer to the notification of the ESRB on the undertaken measure and conducted analysis, the need for reciprocity of this measure and the materiality threshold, after which the ESRB would decide on whether to recommend to member states to reciprocate measure of the candidate or potential candidate country;
- National regulatory frameworks of the EU candidate and potential candidate countries would provide for a parallel procedure for reciprocation measures of EU Member States.

Our proposal allows for possibility for the establishment of reciprocity of macroprudential measures between the EU Member States and the EU candidate and potential candidate countries in a relatively short time. If the ESRB adopts the recommendation, it would depend solely on how quickly EU candidate and potential candidate countries would adopt parallel frameworks as a condition of reciprocity. In this way our proposal could make contribution to the national, regional and financial stability of the EU. In addition, it could contribute to further rise of public confidence in the effectiveness of macroprudential policy as the new public policy area, which is at its beginning of proving its effectiveness in mitigating systemic risks and reducing the risk of financial crises in the world.

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