CENTRAL BANK OF CYPRUS
EUROSYSTEM

MACROPRUDENTIAL POLICY:

INTERMEDIATE MACROPRUDENTIAL POLICY OBJECTIVES & SELECTION OF MACROPRUDENTIAL INSTRUMENTS

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80 Kennedy Avenue, CY-1076 Nicosia, Cyprus
Postal Address: P.O.Box 25529, CY-1395 Nicosia, Cyprus
Telephone: +357-22714100 - Website: www.centralbank.gov.cy

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1. Introduction

Financial stability can be defined as "a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding any shocks and the unravelling of financial imbalances. This mitigates the likelihood of disruptions in the financial intermediation process that are severe enough to significantly impair the allocation of savings to profitable investment opportunities[1]".

The global financial crisis has highlighted the need for macro-prudential oversight in order to mitigate and prevent the build-up of systemic risk in the financial system; where systemic risk is defined as the risk of disruption in the financial system with the potential to have serious negative consequences for the internal market and the real economy[2]. Consequently, the establishment of a sound macro-prudential policy framework, alongside micro-prudential supervision, will enhance the effectiveness of macro-prudential oversight and enhance the resilience of the financial system against systemic risks; thus, providing the necessary conditions for economic growth.

In response to the global financial crisis, a number of initiatives were taken. Firstly, the European Systemic Risk Board (ESRB) was formed and was charged with the responsibility of the macro-prudential oversight of the EU financial system. The ESRB has, *inter alia,* issued a recommendation on the macro-prudential mandate of national authorities (Recommendation ESRB/2011/3) and a recommendation on the means of implementing macro-prudential policy through the establishment of intermediate objectives and instruments (Recommendation ESRB/2013/1). Moreover, the Capital Requirements Regulation[3] and the Capital Requirements Directive[4] (CRR/ CRD IV) envisage a set of macro-prudential instruments to prevent and mitigate macro-prudential and systemic risks.

At the national level, the Central Bank of Cyprus (CBC), as the designated national macro-prudential authority, is responsible for the "macro-prudential oversight of the financial system with the ultimate objective of contributing to the safeguarding of the stability of the financial system", as explicitly stated in the *Central Bank of Cyprus Law, 2002 - (No. 3) 2014*. The *Central Bank of Cyprus Law* clearly requires the CBC to identify, monitor and assess risks to financial stability and implement policies to prevent or mitigate those risks, when conducting macro-prudential oversight of the financial system. In addition, the Central Bank of Cyprus is the designated national authority responsible for the implementation of the macro-prudential instruments available in the CRR/ CRD IV[5].

Within the Single Supervisory Mechanism, the ECB also has a macro-prudential supervisory mandate and may propose stricter requirements than those applied by the national authorities.

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[1] ECB (2011).

[2] Regulation (EU) No 1092/2010 of the European Parliament and of the Council of 24/11/2010 on European Union macro-prudential oversight of the financial system and establishing a European Systemic Risk Board.

[3] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012.

[4] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[5] Macro-prudential Oversight of Institutions Law 6(I) of 2015.

The Recommendation of the European Systemic Risk Board of 4 April 2013 on the intermediate objectives and instruments of macro-prudential policy (Recommendation ESRB/2013/1) sets out, *inter alia*, these recommendations:

Recommendation A – addressed to the macro-prudential authorities on the definition of intermediate objectives

Recommendation B – addressed to the member states on the selection of macro-prudential instruments

In the timeline for the follow-up to Recommendation ESRB 2013/1, macro-prudential authorities and member states are requested to communicate a report to the ESRB, the European Banking Authority (EBA) and the Council explaining the measures undertaken in order to comply with the content of the recommendations.

This report outlines how the CBC has complied with Recommendations A and B on the intermediate objectives of macro-prudential policy and on the selection of macro-prudential instruments to be applied to mitigate systemic risks respectively, as required by Recommendation ESRB/2013/1.

2. Intermediate macro-prudential policy objectives

The ultimate objective of macro-prudential oversight of the financial system is to contribute to the safeguarding of the stability of the financial system as a whole by, *inter alia*, strengthening the resilience of the financial system and decreasing the build-up of systemic risk, thereby ensuring a sustainable contribution of the financial sector to economic growth.

To achieve this ultimate objective, intermediate objectives of macro-prudential policy need to be identified allowing for greater accountability and transparency in policy decisions. The macro-prudential intermediate objectives are selected on the basis of underlying market failures and the specific structural characteristics of the financial system of Cyprus that could give rise to systemic risks. Identifying intermediate objectives on the basis of specific market failures allows for a clearer classification of macro-prudential instruments; ensures an economic base for the calibration and use of those instruments; and fosters accountability.

The CBC has identified the following macro-prudential intermediate objectives:

1. Mitigate and prevent excessive credit growth and leverage
2. Mitigate and prevent excessive maturity mismatch and market illiquidity
3. Limit direct and indirect exposure concentrations
4. Limit the systemic impact of misaligned incentives with a view to reducing moral hazard
5. Strengthen the resilience of financial infrastructures.

The CBC periodically assesses the need for further intermediate objectives, in view of the experience gained in operating the macro-prudential policy framework, structural developments in the financial system and the emergence of new types of systemic risk.

3. Selection of macro-prudential instruments

Macro-prudential instruments are the means by which the intermediary and ultimate objectives of macro-prudential policy are achieved. The establishment of a set of macro-prudential instruments to be effectively applied when there is a call for macro-prudential policy action is thus a precondition for the success of macro-prudential policy. Therefore, under national law, the CBC is empowered with the development and application of appropriate macro-prudential instruments for the macro-prudential oversight of the financial system[6].

The CBC, as the designated authority for the purposes of the macro-prudential instruments defined under the CRD IV / CRR, as transposed into national legislation[7], may issue directives which shall publish in the *Official Journal of the Republic of Cyprus*. Also, the introduction of any other macro-prudential instrument is possible through the issuance of specific or general circulars or directives addressed to the components of the financial system as a whole or per group or per financial institution, financial undertaking or entity[8].

Table 1 links the intermediate objectives with macro-prudential instruments to achieve the intermediate objectives. The list is non-exhaustive. The instruments have been selected on the basis of their:

(a) *effectiveness*, i.e. the degree to which the instrument can address market failures and achieve the ultimate and intermediate objectives; and
(b) *efficiency, i.e.* potential of the instrument to achieve the ultimate and intermediate objectives at minimum cost.

Table 1: Macro-prudential instruments

Intermediate objective	Macro-prudential instrument
Mitigate and prevent excessive credit growth and leverage	i. Countercyclical capital buffer ii. Sectoral capital requirements (including intra-financial exposures) iii. Leverage ratio iv. Loan-to-value (LTV) limits v. Loan-to-income (LTI) / debt (service)-to-income (DSTI) limits vi. Systemic risk buffer vii. Additional own funds requirements viii. Increased capital conservation buffer
Mitigate and prevent excessive maturity mismatch and market illiquidity	i. Macro-prudential adjustment to liquidity coverage ratio (LCR) ii. Macro-prudential restrictions on funding sources (Net Stable Funding Ratio - NSFR) iii. Macro-prudential un-weighted limit to less stable funding (loan-to-deposit and loan-to-stable funding limits) iv. Liquidity surcharge (general liquidity surcharge and liquidity surcharge for Systemically Important Institutions (SIIs)) v. Margin and haircut requirements vi. Additional reporting requirements

[6] *Central Bank of Cyprus Law, 2002 - (No. 3) 2014.*
[7] *Macro-prudential Oversight of Institutions Law, 6(I) 2015.*
[8] Article 47A(7) of *Central Bank of Cyprus Law, 2002 - (No. 3) 2014.*

Intermediate objective	Macro-prudential instrument
Limit direct and indirect exposure concentration	i. Sectoral capital requirements (including intra-financial) ii. Systemic risk buffer iii. Large exposures restrictions (including intra-financial) iv. (Sectoral) loan-to-value (LTV) limits v. (Sectoral) loan-to-income (LTI) / debt (service)-to-income (DSTI) limits vi. Additional own funds vii. Public disclosure requirements viii. Central counterparties (CCP) clearing requirement
Limit the systemic impact of misaligned incentives with a view to reducing moral hazard	i. Global systemically important institutions (G-SII) buffer ii. Other systemically important institutions (O-SII) buffer iii. Systemic risk buffer iv. Additional own funds v. Increased capital conservation buffer vi. Liquidity surcharge for SIIs vii. Public disclosure requirements
Strengthen the resilience of financial infrastructures	i. Margin and haircut requirements on central counterparties (CCP) clearing ii. Public disclosures requirements iii. Systemic risk buffer

The CBC periodically reviews the effectiveness and efficiency of the macro-prudential instruments selected in achieving the ultimate and intermediate objectives of macro-prudential policy. If based on the review, the establishment of new macro-prudential instruments is considered to be necessary the CBC accordingly designs the appropriate instruments.

References

ECB (2011) *Financial Stability Review*, May 2011.

ESRB (2011) *Recommendation on the macro-prudential mandate of national authorities (Recommendation ESRB/2011/3)*.

ESRB (2013) *Recommendation on intermediate objective and instruments of macro-prudential policy (Recommendation 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.