Speech of the Chairman of the Board of Bank of Lithuania Vitas Vasiliauskas on macroprudential regulation and financial stability

Dear Governor Kallaur, Ladies and Gentlemen,

It is my great pleasure to join you at this High-Level International Forum – and to celebrate the 25th Anniversary of the Belarusian Ruble. Congratulations on this important milestone.

Financial stability is key to ensuring trust in any currency. Therefore, the topic I was invited to discuss today – namely, macroprudential regulation – fits the occasion well.

In my remarks, I will consider three dimensions to macroprudential policy-making: the international, the European, and the domestic, or national, level.

Let's begin with a broader international perspective.

The global financial crisis taught us a lesson: microprudential regulation and supervision alone are not enough to safeguard the financial system. Vulnerabilities may build up across the financial sector through complex interlinkages – even though individual entities may seem stable on a standalone basis.

The crisis was thus a catalyst for the rise of macroprudential policies. The focus turned to ensuring the stability of the financial system as a whole. International cross-cutting post-crisis reforms – such as Basel III – helped accelerate this process.

Today, over 90% of world economies have at least one macroprudential policy measure in place. The average number of measures per country is more than nine[1].

In other words, macroprudential policy has become mainstream. A saying was even born, paraphrasing Milton Friedman, that "we are all macroprudentialists now"[2].

Of course, the macroprudential domain differs across regions.

In emerging market countries, tools to manage foreign exchange mismatches in the banking system are more popular than in advanced economies. Such measures include, for example, limits on the net foreign exchange position.[3] Many countries also differentiate liquidity tools and reserve requirements by currency. By minimising foreign exchange lending risks and encouraging local currency savings, these instruments can directly strengthen the role of local currencies.

Across the advanced economies, bank capital measures are the top choice. And, in recent years, more countries are activating borrower-based instruments, such as restrictions on loan-to-value and debt-to-income or debt-service-to-income ratios. The usage of such measures is related to high levels of mortgage lending, and the overall experience with housing sector vulnerabilities in these economies.

These are some of the examples of the growing number of macroprudential measures used across the world. Have they been effective in ensuring financial stability?

Let us not be too optimistic: financial crises have always happened and will always happen. However, macroprudential policy can surely mitigate the most harmful manifestations of the financial cycle – especially in the current low interest rate environment that encourages excessive risk-taking.

Surely, more research is needed on the topic. But the evidence is mounting, particularly in terms of loan-targeted instruments. For instance, many papers, including IMF research, have found that loan-to-value and, especially, debt-service-to-income limits can reduce household credit growth and house prices.

Dear Colleagues,

Prior to the global financial crisis, only a few countries in the EU made use of macroprudential measures, and there was a great deal of uncertainty over which instruments to choose – and how to calibrate them.

But that has changed. I would therefore like to quickly zoom in on the European dimension.

During the post-crisis period, macroprudential authorities came into existence in almost all EU Member States[4], and the policy toolkit was built up. Important Basel III measures – such as the countercyclical capital buffer and the buffer for systemically important institutions – were transposed into EU law[5].

Today, all EU Member States have set and regularly review the buffers for their domestically and globally systemically important institutions, while a positive countercyclical capital buffer rate has been active or announced in 12 of the Member States.

Borrower-based measures have not been fully harmonised at the EU level. Nevertheless, they have already been implemented in 17 Member States to curtail credit growth and household leverage.

Harmonised or not, macroprudential measures have been implemented in a relatively consistent manner across Europe. This is due, in part, to the comprehensive governance structure that was set up after the crisis. This structure features a two-tier system. Countries are first in line to counter systemic risk. In the euro area, the ECB is responsible for assessing measures adopted by national authorities – and applying higher requirements if deemed necessary. The European Systemic Risk Board brings together all the relevant institutions to carry out oversight, and issues recommendations or warnings – for all EU Member States and EU institutions.

Dear colleagues,

We have talked about international and European perspectives. But final decisions on macroprudential policy are taken at the national level. This is where instruments are calibrated and adopted to country-specific circumstances. Macroprudential policy-making is still a rather novel exercise: one can say that every country engages in a sort of experiment to find the right medicine.

In Lithuania, the central bank became the macroprudential authority in 2014. Indeed, it is a very important mandate. Lithuania does not have domestically orientated monetary policy as we have been part of the Eurosystem since 2015. For that reason, proactive use of macroprudential measures has become the main roadblock against the build-up of cyclical systemic risks in the country's financial system.

Unfortunately, we did not have such safeguards 10 years ago, when we were hit particularly hard by the boom-and-bust cycle. House prices dropped sharply – by 30% in 2009, which was the second-worst drop in the whole EU.

I think this taught us a lesson. In the post-crisis years, Lithuania has been eager to find an effective combination of macroprudential policy measures. In 2011, we were among the first in the EU to establish restrictions on loan-to-value, debt-service-to-income, and loan maturity.

I have to say that, in introducing those measures in 2011, we did so without having a clear legal mandate. We introduced them by using secondary legislation, based on general provisions under the law governing the functioning of the Bank of Lithuania. As I mentioned, we only received a clear legal mandate for implementing macroprudential policy three years later. From a legal point of view, the step we took in 2011 was a risky one, but nobody challenged it – perhaps due to the still-recent memories of the 2008-2009 crisis.

Going further, in 2015, to promote responsible lending in a low interest rate environment, we introduced a limit on debt-service-to-income, while also introducing an interest rate shock element. At the same time, loan maturity limit was reduced.

Taken together, this is one of the largest sets of borrower-based measures in the EU. It has created a reliable backstop against the deterioration of lending standards. Combining different instruments helps prevent evasion, targets a wider range of risk sources, and allows measures to reinforce each other.

We have also been active in strengthening banks' capital. Macroprudential capital buffers were introduced as soon as they became available in the European regulation and thus domestic law – starting from 2015. To prepare against potential shocks in the future, the countercyclical capital buffer rate in Lithuania has been raised twice, and now stands at 1%. We see this buffer as a reserve, which could be loosened in bad times to encourage bank lending to the real economy.

Today, the Lithuanian economy is still expanding above its potential – according to our estimations, it will grow by 3.7% this year. Despite this, we do not see signs of irresponsible behaviour on the part of creditors or borrowers.

Much of this can be attributed to sound macroprudential policy. For instance, our assessment reveals that had we not introduced borrower-based measures, house prices would be at least around 7% higher today, and loan stock to households would be around 10% larger.

I am glad that macroprudential policy is also on the agenda of the National Bank of the Republic of Belarus. You have in place the main capital buffers in line with Basel standards, as well as the key borrower-based measures.

Here I must stress that macroprudential policy is not only about measures, but also about the overall framework. In order to achieve financial stability, clear powers and responsibilities should be defined. These are the steps that the National Bank of the Republic of Belarus is taking.

In terms of the framework, institutional independence is also key. The task for macroprudential authorities is to "take away the punch bowl as the party gets going." Those in the party may prefer it to continue. Authorities should thus be autonomous from outside pressures to be able to ensure an effective implementation of the mandate.

In Belarus, some of the important work on the macroprudential framework was done during an EU Twinning project dedicated to enhancing the potential of the National Bank of the Republic of Belarus. The Bank of Lithuania had the opportunity to participate in the project and took a leading role in the Financial Stability component.

For us, it was a great experience. I would like to thank the experts and the Board of the National Bank for their outstanding dedication. It has laid a sound foundation for further development of an effective macroprudential policy framework in Belarus.

Ladies and gentlemen,

To conclude, macroprudential policy is – so to say – approaching its adolescence, and countries will continue to fine-tune their frameworks and instruments. However, experience with applying these tools is growing.

I am confident that through knowledge-sharing and international cooperation, macroprudential policy will play an increasingly important role in safeguarding financial stability – in all parts of the world.

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[1] IMF (2018), The IMF's Annual Macroprudential Policy Survey—Objectives, Design, and Country Responses.

[2] Milton Friedman's famous line ran: "We are all Keynesians now".

[3] Net Foreign Exchange Position is defined as the difference between assets and liabilities in a foreign currency.

[4] All Member States but one (Italy) now have a dedicated macroprudential authority in place. In Italy, the role of setting macroprudential measures (available in the common EU regulation) is currently carried out by the Bank of Italy.

[5] The CRR/CRD IV rules provide for the common regulatory framework for macroprudential supervision.