Box 3.3

NEW MACROPRUDENTIAL TOOLS APPLICABLE TO THE ACTIVITY OF CREDIT INSTITUTIONS IN SPAIN[1]

Royal Decree-Law 22/2018 and Royal Decree 102/2019 empowered the Banco de España to develop a new macroprudential toolkit applicable to the banking sector to address systemic risks, including a sectoral countercyclical capital buffer (SCoCCyB), which is built in as an additional component of the countercyclical capital buffer (CCyB), sectoral concentration limits (SCLs) for credit exposures, and limits and conditions on lending and other transactions (known internationally as Borrower-Based Instruments or BBIs). This regulatory development is part of a broader reform establishing the Spanish macroprudential authority (AMCESFI) and allocating new macroprudential tools to the three sectoral supervisory authorities: the Banco de España, the National Securities Market Commission (CNMV) and the Directorate General of Insurance and Pension Funds (DGSFP).

In this setting, on 2 February the Banco de España submitted a draft amendment of Circular 2/2016 on the supervision and solvency of credit institutions for public consultation[2,3]. This reform aims, firstly, to establish new CCyB regulation that is consistent with the revised wording of Article 45(1) of Law 10/2014 and which allows the Banco de España to require such a buffer both for all the credit exposures of an institution and for those to a specific sector (i.e. the SCoCCyB, defined as a sectoral component of the CCyB). Likewise, the reform implements regulations on the setting of SCLs for credit exposures and also of certain limits and conditions on the granting of BBIs.

The Banco de España, as the designated authority for using macroprudential tools for the banking sector, is responsible for safeguarding financial stability by seeking to prevent systemic financial shocks that could have an adverse impact on the real economy. To this end, it must have at its disposal the tools needed for carrying out this task effectively[4].

The aim of the SCoCCyB is to contain the systemic risk arising from potential imbalances (excessive credit growth) that may emerge in a given economic sector, by seeking to alter the relative cost, in regulatory capital terms, of lending to that sector. In turn, in order to avoid undesirable side-effects stemming from its application, the reaction of other sectors must be monitored in order to prevent the excessive credit growth from shifting to them. The SCoCCyB also seeks to provide institutions with sufficient capital to cope with potential losses from a disorderly propagation of the imbalances originating in the sector where excessive credit growth is detected.

Implementation of the SCoCCyB must strike an appropriate balance between the accuracy and the scope of the definition of the economic sectors giving rise to the imbalances. Historical evidence shows that, in previous crises, most systemic risks were concentrated in exposures to specific economic sectors, as was the case for the real estate sector in the run-up to the global financial crisis (see Chart 1). However, the definition of the sectors subject to this measure must be broad enough to ensure that the tool has the broad-based scope proper to its macroprudential purpose. Empirical evidence suggests that the SCoCCyB should generally be activated at the earliest stages of the build-up of the systemic risk. Its release should be immediate if the systemic risk materialises and progressive if it gradually subsides.

The SCL tool limits the total volume of credit exposures to a specific sector. This limitation is defined relative to a capital metric, not as a limit on the absolute level of exposure. Thus, if a particular institution decides to further increase its exposure to a sector subject to such limit, it may do so as long as it sufficiently increases its capital levels. In this way, it would be able to cope with potential losses in the sector in which the systemic risk builds up. Chart 2 shows how exposure to real estate credit grew relative to bank capital before the global financial crisis and how this was subsequently corrected.

As the SCL is also a sectoral tool, some of its features are analogous to those of the SCoCCyB. Again, this requires a cautious analysis of the potential spillovers to

1 This box is based on the content of C. Trucharte Artigas (2021), "Nuevas Herramientas Macroprudenciales para las entidades de crédito", Revista de Economía, No. 918, ICE.

2 See Banco de España Circulars for further details on this public consultation and for the draft circular.

3 Under Royal Decree-Law 22/2018, new macroprudential tools were made available to the Banco de España and the other Spanish sectoral supervisory authorities. In the banking sector, Royal Decree-Law 22/2018 extends the toolkit already available under Law 10/2014.

4 C. Castro and A. Estrada present an empirical analysis of the effectiveness of these new instruments available to the Banco de España in "Completando el conjunto de herramientas de la política macroprudencial en España: los nuevos instrumentos a disposición del Banco de España", Financial Stability Review, Spring 2021, Banco de España (forthcoming).

Box 3.3

NEW MACROPRUDENTIAL TOOLS APPLICABLE TO THE ACTIVITY OF CREDIT INSTITUTIONS IN SPAIN (cont'd)

Chart 1
TOTAL AND SECTORAL (real estate credit) CREDIT-TO-GDP GAPS (a)

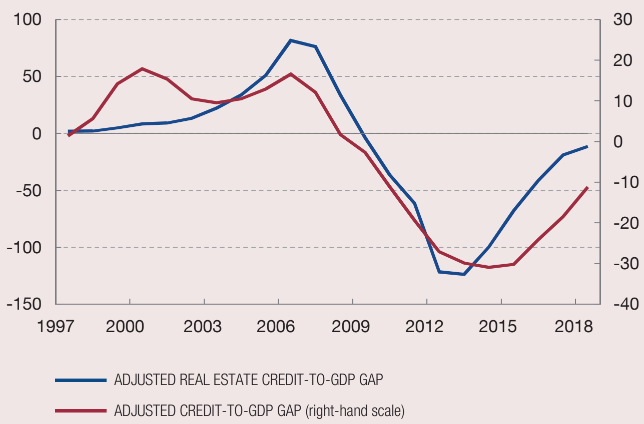
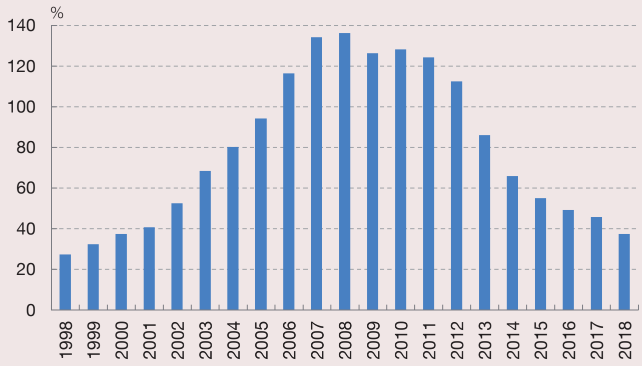


Chart 2
RATIO OF REAL ESTATE CREDIT TO TOTAL CAPITAL



SOURCE: Banco de España.

a Credit-to-GDP gaps correspond to December data for each year.

other sectors that might be produced by limits in a specific sector, and the proper identification of sectors with an effect on systemic risk. The key difference between this tool and the SCoCCyB is that its activation would limit sectoral credit concentration growth more directly (as this would be done via a restriction on quantity), while the SCoCCyB would act more via disincentives, by making it more expensive, in relative capital terms, to increase the credit exposure to the sector or sectors for which it has been activated. For this reason, the SCL can be generally considered as a last resort, to be used in the later stages of the unfolding of the systemic risk when the other tools have proved to be ineffective. However, in special circumstances it could also be used earlier. It should be immediately deactivated upon materialisation or dissipation of the systemic risk.

BBIs monitor credit standards in the granting of financing (for example, value of collateral, term, capacity to repay the loan). The available evidence suggests that loans granted under lax criteria, be it in terms of the value covered by the required collateral, leverage, the debt-to-income ratio required of borrowers or maturity, entail higher repayment risks down the line[5].

The decision to set limits on some characteristics rather than others will depend on the nature of the systemic risk, and the most effective alternative for its mitigation will be decided accordingly. However, it must be borne in mind that setting limits on a particular characteristic may lead to easing others, requiring action to be taken on several characteristics at the same time. Moreover, the easing of standards may spill over to other credit portfolios, requiring the measures to be extended to them.

BBI regulation should also provide for the possibility of adjusting the limitations according to the characteristics of the borrower and the lender, thus ensuring their effectiveness and that they do not impinge disproportionately on a specific group or hinder other public policy measures. These limitations through BBIs would be activated on an individual basis or jointly and will be in place alongside other macroprudential tools. Generally speaking, this instrument should be activated in the intermediate stages of the build-up of the systemic risk.

The reform of Circular 2/2016 thus expands the toolkit that has to date been available to the Banco de España, in its role as designated authority for the use of macroprudential instruments for the banking sector. These tools are specifically designed to control systemic risk and would therefore make it possible to limit, for example, the potential adverse effects that an overly lax

5 See J. Galán and M. Lamas (2019), "Beyond the LTV ratio: new macroprudential lessons from Spain", Working Paper No. 1931, Banco de España, for an empirical analysis of the impact of mortgage credit standards in Spain on default behaviour.

Box 3.3

NEW MACROPRUDENTIAL TOOLS APPLICABLE TO THE ACTIVITY OF CREDIT INSTITUTIONS IN SPAIN (cont'd)

monetary policy could have on excessive risk-taking by agents. These tools can also be adapted to the financial cycle and to specific shocks in the Spanish banking sector. These features are very useful for building resilience and the capacity to absorb unexpected shocks, as evidenced by the current economic crisis arising from the COVID-19 pandemic. The fulfilment of these objectives of the new framework will need to be underpinned by the Banco de España's risk analysis capabilities and a measured application of this new wide-ranging toolkit.