

Macroprudential policy objectives

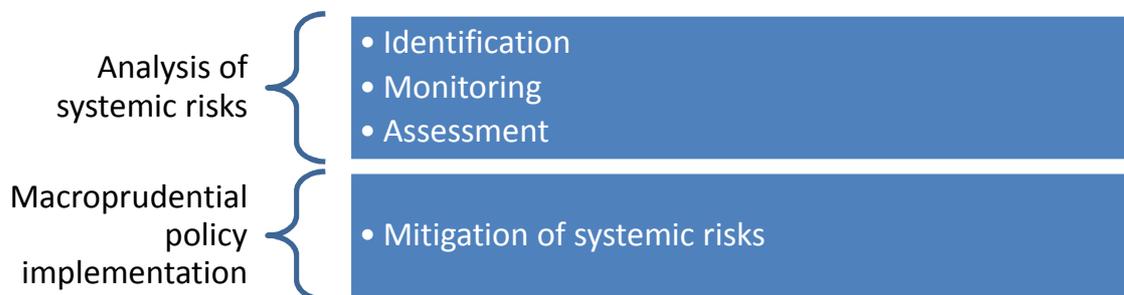
The financial sector fulfils certain basic functions in the economy (e.g. payments, financial intermediation, transfer of risk, management of the financial market infrastructure, etc.). If these functions are performed properly, the financial sector has the potential to contribute to economic growth. If, however, these functions are not performed properly, they can lead to the formation of instability or imbalances in the economy and the exacerbation of any economic downturn.

Financial stability is where the financial sector as a whole is able to smoothly fulfil its basic functions even at times of major negative shocks in either the external or domestic economic and financial environment. Financial sector stability is correspondingly seen as a prerequisite for the healthy functioning of the real economy, while the behaviour of the financial sector should not deepen the economic cycle. Národná banka Slovenska contributes to the stability of the financial system as a whole, principally by exercising supervision over financial markets.

Financial stability is contingent on the financial health and sound internal processes of financial institutions. Financial market supervision focuses on the stability of individual financial institutions and the exposure of financial entities to specific risks. The financial crisis of recent years has, though, shown supervision defined in such narrow terms is unable to ensure financial stability. Therefore, macroprudential policy has been established as a new way of ensuring the stability of the financial system as a whole.

The core and strategic objective of macroprudential policy is to contribute to maintaining the stability of the financial system as a whole. This includes, in particular strengthening the resilience of the financial system and reducing systemic risk, thereby ensuring the financial system's sustainable contribution to economic growth. The role of macroprudential policy is to identify, monitor and mitigate systemic risks for the financial system. The conduct of macroprudential policy consists of two main stages, namely the analysis of systemic risks and the actual implementation of policy in the form of risk mitigation.

Basic processes of macroprudential policy

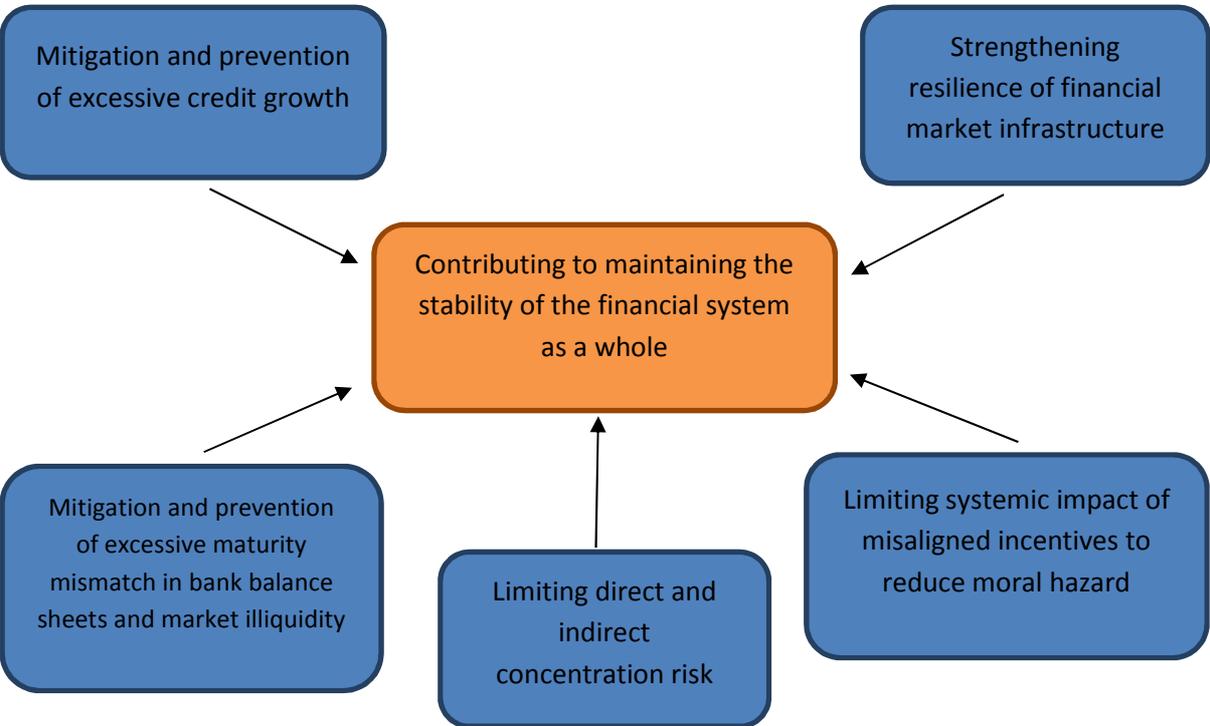


Financial stability is also significantly affected by other financial market participants – non-financial corporations, households and government – as well as by the legislative and regulatory environment. Národná banka Slovenska, therefore, believes that an important

aspect of its contributing to financial stability is to keep the public regularly informed about financial sector stability and about any trends that could jeopardise that stability. For this purpose, Národná banka Slovenska publishes twice yearly a Financial Stability Report, which focuses primarily on identifying the main risks to the stability of the financial sector in Slovakia.

Intermediate macroprudential policy objectives

The core policy objective, which is a strategic objective, can be broken down into selected intermediate objectives¹. The choice of intermediate objectives should largely correspond to the current state and threats that can be expected in the sector over the medium-term. Defining intermediate objectives allows greater operational flexibility in policy implementation and also allows for greater transparency.



Mitigation and prevention of excessive credit growth and leverage

This is one of the main sub objectives of macroprudential policy. The objective is based on the fact that most financial crises to date have been associated with excessive credit growth. Examples are Ireland and Spain, where the crisis development was very closely linked with excessive growth in housing loans. Risk accumulates particularly at times of growth. Under the pressure of competition and pressure for profit growth, financial institutions often underestimate risk in new lending. Such behaviour also tends to emerge at the level of the entire sector.

¹ Determination and definition of sub-objectives is based on the Recommendation of the ESRB (ESRB/2013/1) of 4 April 2013 on intermediate objectives and instruments of macro-prudential policy.

The impact of this development can be quite significant, both for the financial sector itself as well as for the economy as a whole. In most cases excessive credit growth is followed by a credit crunch, when banks are unwilling to provide loans in the real economy. At the same time fears arise regarding banks' health, manifested in distrust between banks, as well as from the customers.

Mitigation and prevention of excessive maturity mismatch in bank balance sheets and market illiquidity

A healthy structure of financing is one of the basic conditions of a stable financial system. Whereas a maturity mismatch between assets and liabilities is an inherent feature of banks' business, the objective is to mitigate risks arising from this mismatch. On the one hand, banks should have a sufficient volume of liquid assets that they can liquidate if necessary; on the other hand the funding structure should include substantial share of stable funds from customers.

Unhealthy bank balance-sheet structures in terms of liquidity can negatively affect trust between financial institutions, as has been seen in recent years in several EU banking sectors. Banks in this position are also constrained in their ability to lend.

Limiting the risk of direct and indirect concentration

This is a risk of a structural nature, which arises in cases of a significant concentration of exposure towards a particular asset class. With such concentration the financial sector's sensitivity to the asset's development also rises. Its importance rose in particular in relation to the debt crisis among euro area countries, when even government bonds that had long been perceived as risk-free proved to be a significant source of risk. A further source of risk may be a high concentration in corporate loans or in exposures toward other banks.

The essential aspect of this risk is its significant and relatively rapid impact on financial institutions. It is also manifested in a collapse in confidence in the banking sector both from the side of customers as well as financial institutions. Depending on the degree of concentration toward risky assets, the impact on the real economy is also negative.

A specific type of risk in terms of macroprudential policy is the exposure of multiple institutions to a common source of risk. This exposure need not be significant in terms of the degree of direct risk from the perspective of individual institutions, though, given its presence at multiple institutions, it can pose a systemic risk in terms of the financial market as a whole. An example from the pre-crisis period is the exposure of a relatively large number of domestic banks to the commercial real-estate sector.

Limiting the systemic impact of misaligned incentives to reduce moral hazard

Risk arises from the existence of mechanisms present in the financial system, be they short-term or long-term, which tend to accumulate systemic risks or create more risky behaviour in a certain group of financial institutions. A typical example is the existence of systemically important banks that, through their size, create the problem of being “too-big-to-fail”. A further mechanism tending to produce riskier behaviour is, for example, existing regulation that evaluates EU government bonds as risk-free.

The main risk of systemically important banks occurs when such banks get into existential problems. Rescuing them can significantly impact on the government’s finances, with negative effects then overflowing into the entire national economy. An example here is the rescue of major Irish banks.

Strengthening the resilience of financial market infrastructure

The aim is to identify and mitigate risks of a structural nature posing a threat to financial market infrastructure. One of the main objectives in this area is to monitor the interaction between individual sectors, or individual institutions in the domestic financial market, or possible contagion in the case of deterioration in the situation at some institutions. An important area is the monitoring of the significance of the shadow banking sector. In Slovakia this concerns primarily the development of lending at consumer credit companies or other sectors.