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It is time to expand macro-prudential framework in the non-banking sector

In the view of many investors, the low and even negative interest rate environment (LIRE) has slowly become the most prominent risk that threatens the stability of the financial system in the EU. It has, perhaps, even become the new normal as depressed interest rates marked the entire decade. Although these developments are somewhat lagging in Croatia, as interest rates are relatively higher compared to other EU countries due to national idiosyncratic reasons, they are highly relevant because both banking and non-banking financial sectors are heavily exposed to domestic government bonds, whose long-term yields are rapidly converging towards zero. Insurance companies and pension funds are especially vulnerable to LIRE risks due to their business profiles, which are characterized by negative duration gaps, particularly those that issue products with guaranteed rates and defined benefit pension plans.

While direct risks that negatively affect stability of the financial system are notable, what is more important is the indirect effect that LIRE has on the system through its negative effect on economic activity, which continues to be subdued more than ten years after the global financial crisis. There is a growing consensus that current environment characterized by low interest rates and anemic growth is more determined by structural factors (declining productivity of companies and falling profitability that hinders new investments and contributes to the accumulation of the excess savings, increasing social inequalities, negative demographic trends and risk aversion) than cyclical factors (relaxed monetary policy, over-indebtedness of private and public sectors).

Therefore, the discussion regarding the LIRE should be broadened to emphasize its effect on real economic activity, which eventually impedes the profitability of financial institutions. In order to successfully restart the economic and financial progress in the EU, organized collective effort of all policyholders is needed, such that would focus on long-term and broad-based goals. More specifically, long-term view should take into account sustainability and environmental impact of long-term investments, while broad-based view should be socially sensitive and inclusive. Some steps in the right direction have been made to reach these goals, but majority of the road still lies ahead.

Since we are finding ourselves in uncharted waters, growing emphasis is, and will continue to be, placed on unconventional policy, more specifically on macroprudential policy actions. Therefore, policymakers should utilize the present relatively stable environment to further improve macroprudential regulation focusing on cross-border and cross-industrial harmonization of macroprudential rulebook. Even though macroprudential regulation in banking sector has made significant leaps following the global financial crisis, progress in non-banking sector is still lagging, which creates possibilities for regulatory arbitrage. The significance of closing this regulatory gap is even more highlighted by the rising importance of the EU non-banking sector as (investment and pension) funds and insurance companies are steadily increasing in size, are becoming highly connected (directly and, more importantly, indirectly) with the rest of the financial sector and are strengthening their relevance as a source of funding for the real economy.

In other words, policymakers should work proactively to improve their macroprudential toolboxes, following the banking example but also taking into account industries' specificities and the current macroeconomic and financial environment (LIRE), while simultaneously improving the resilience of financial system in order to support sustainable long-term investments. ●