Towards an operational macro-prudential approach: elements of a framework and policy challenges

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Disclaimer

The opinions expressed are the author’s own and do not necessarily reflect those of the Bank for International Settlements
Systemic crises are always “macro”

The financial system has been “sick” for two years

- **Financial sector** immense losses and failures, malfunctioning funding markets, disrupted credit flows
- **Real sector** serious recession

- A systemic event
- Strong interactions between real and financial sector

- Not a new phenomenon:
  - Japan’s lost decade, Nordic countries’ crises
  - Headwinds in US, UK, Spain in early 1990s
  - Great Depression and banking panics in 19th and early 20th centuries
Policy responses should also be “macro”

Strengthen the “macro-prudential” approach to financial stability

- **Unit of analysis** the system not the individual institution
  - “portfolio” approach

- **Emphasis on interactions:**
  - within the financial system (markets and institutions)
  - between the financial sector and macroeconomy
“Macro” vs “micro”

- Micro perspective and the “fallacy of composition”:
  - What is individually rational may not be optimal in aggregate
  - Focus on component stability not sufficient
- Macro perspective and “endogenous” risk
  - Behaviour amplifies risk by ignoring interdependencies
- Complementarities between the two approaches
- Similarities in the macro-prudential perspective with that of other areas of policy: monetary, fiscal
Elements of a macro-prudential approach

- Definition of objective
- Measurement of policy targets
- Instrument design and calibration
- Governance

...Challenges in all dimensions
I. Defining financial stability

- The elusive definition of financial stability
  - Often defined as the opposite of instability

- Ideally: a measure of system’s ability to intermediate credit and allocate risk

- Easier to think in terms of a single institution (e.g. VaR target) than for the system as a whole

- Model-based proxies “under construction”
II. Measurement of target

Quantitative targets and performance benchmarks are always useful for policy

- Time-dimension (procyclicality)
  - Build up of financial system risks typically during benign economic conditions
  - “Myopia” or short memory span?
  - Longer horizon risk analysis of business and financial cycle
    - EWI, dynamic general equilibrium models, rules of thumb
  - Policy needs to **go against the flow**: difficult but necessary
II. Measurement of target

- Cross-sectional dimension (risk concentration at a point in time)
  - Structured analysis of component interactions
    - Common exposures, counterparty links, strength of domino effects
  - Data availability, coverage and meaningfulness
    - Correlations, interlinkages, international dimension
  - Trickiest: assessment of the “endogenous” component
    - Second round effects, adding up constrains, liquidity
  - Value added of “macro” perspective
III. Design and calibration of tools

- Some policy instruments exist but require recalibration and some need to be created anew.

- Existing, risk-sensitive tools need to be re-calibrated to account for:
  - interactions and endogenous risk;
  - re-focused on systemic rather than institution solvency

- New instruments that are targeted to systemic risk
III. Design and calibration of tools

Existing tools

- Capital
  - Procyclicality adjustment, systemic importance

- Provisions
  - Dynamic provisions

- Liquidity requirements

- Margining for counterparty risk
III. Design and calibration of tools

New instruments

● Stress testing
  • Requiring the explicit analysis of feedback effects and aggregate behaviour

● Winding-down procedures for systemically important institutions

Structural innovations

● Market trading infrastructure, central counterparties

● Redrawing the perimeter of regulated entities

● Monetary policy and financial stability?
IV. Governance

- An institutional architecture for policy making that focuses on both dimensions of systemic risk
  - Who “owns” macro-prudential policy making?
- Clear objectives, accountabilities and responsibility to exercise powers and use the policy instruments
- Arguably most complicated element of reform towards a more effective “macro” perspective
  - Incentives
  - Responsibilities
  - Corporate culture
IV. Governance

- Many players
  - Supervisors (sectoral or consolidated)
  - Central banks
  - Ministries of Finance
  - Domestic vs International activities (home-host issues)

- Nexus with other macroeconomic policies
- Preference for clear solutions with single entity being accountable
  - Council or single agency
Bottom-line

- Challenges are many, but the time to act is now
- Many initiatives already under way in international forums as well as in individual jurisdictions
- Lots to be learned from sharing experiences
- Political momentum is here to “do something”
- Focus on the positives and accept that even little progress is still progress
- Getting the “science” part right will take time
- Improving governance is key!