Towards a European macroprudential policy

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A key legacy of the financial crisis has been a universal recognition of the importance of systemic risk. As such, systemic risk is not a novel concept, but until the near-catastrophe of late 2008 few understood the scale of destruction that systemic propagation of instability and herd behaviour could wreak in the modern financial system. However, while there is now clarity on the importance of systemic risk, there is much less clarity on how to control it.

Systemic risk and macroprudential policy

Policies to control systemic risk can be loosely classified under the heading 'macroprudential policies'. This is a loose classification, since, although the term 'macroprudential' goes back some three decades, the search for its precise definition is still ongoing. From the late 1990s onwards, most central banks have performed some macroprudential function, and typically their most visible macroprudential effort has been publication of a financial stability review. Although such reviews typically contain useful macroprudential information and analysis, they do not of themselves constitute a macroprudential policy. Presently, there exists no clear concept of what does constitute a macroprudential policy or how one should be developed.

One obvious starting point is to strengthen the systemic orientation of traditional (micro)prudential supervision. Work on this is under way. We may see more widespread use of tools such as 'systemic surcharges' and countercyclical provisions, which should go some way towards limiting the procyclical tendency of the financial system. But we need to be realistic about what can be achieved with normal supervisory tools. Capital regulation cannot anticipate all the various ways in which systemic risks can build up, while supervisory discretion applied by various independent national supervisors is unlikely to add up to an effective countercyclical policy at the European or global level.

Monetary policy has been suggested as another potential tool for controlling systemic risks. Indeed, there has been something of a paradigm shift under way in central bankers' attitudes towards the role of financial stability as an objective of monetary policy. It would be an exaggeration to say that 'leaning against the wind' is the new dogma, but there is now much more widespread recognition that, in future, central banks cannot avoid taking more direct responsibility for financial stability.

At the same time, within the central banking community, the prospect of adopting another objective is met with a distinct lack of enthusiasm. There are widespread concerns about the effectiveness of monetary policy in controlling systemic risks, about the possible economic and political consequences of attempting to do so, and eventually about the possible institutional risks on central bank independence of failing in the attempt.

A third approach to controlling systemic risk would be to create a new policy instrument – analogous to but separate from monetary policy – that would have the sole task of leaning against the wind, to dampen the financial accelerator. Such active, discretionary macroprudential policy is what the Bank of England was referring to when it wrote in a recent discussion paper that: '[m]acroprudential policy is a missing ingredient from the current policy framework'.[1]

There are considerable technical and political hurdles to be negotiated in creating an effective, active macroprudential policy framework. Several candidates for potential instruments have been suggested, but little clarity exists on which, if any, of them might be effective. The political hurdles include deciding on the appropriate institutional setup at the national and, above all, the international level.

The Bank of England discussion paper referred to above offers a good discussion on the technical issues, including the choice of instruments. In short, the debate on the choice of macroprudential policy instruments is still in its infancy. The level of capital requirements has been mentioned as a possible instrument. A closely related idea is to adjust the parameters of provisioning rules in a countercyclical manner. A further possibility is to adjust the risk weights in capital requirements to reflect fluctuations in the macrofinancial environment. Research will over time shed new light on the instrument(s) of choice.

While debate on the instruments is ongoing, it is important to ensure that, once the technical issues are settled, political consensus exists on an institutional framework that allows effective use of the chosen instruments. The present article seeks to contribute to this institutional debate. The particular focus is on how to build a functioning framework for active European macroprudential policies.

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We make a specific proposal on how to improve the capacity of the European Systemic Risk Board to implement effective macroprudential policies. The proposal is ambitious and is to be seen as a medium-term goal rather than a short-term imperative. In the near term, the first priority is to find a consensus on the initial setup of the ESRB, thereby allowing the institution to start its work in early 2011, as planned.

Cross-border externalities

In globalised financial markets, macroprudential policies cannot be effective if they are limited by national borders. Some kind of cross-border cooperation is essential.

[1] Bank of England (2009).

The reason for this is rather obvious: macroprudential actions entail externalities. These relate partly to the international and interconnected nature of financial markets and institutions: reduction of financial risks in one country benefits financial stability globally. They also relate partly to the fact that the provision of financial services is a mobile industry and can be easily relocated: a country tightening macroprudential policies in isolation might find its corporations accessing financing from abroad, and it could even face an increased emigration of financial services providers to other financial centres. Such externalities could have sufficient weight as to render nationally based macroprudential policies timid and ineffective.

Trends in financial market behaviour are often global, or at least widely shared. When asset prices grow fast, leverage increases and pricing of risk declines in one country, the same is likely to be true for another country, provided that each country has a reasonably liberalised capital account. We might argue that, due to the high cross-country correlation of financial trends, macroprudential policies should in any case exhibit a high level of correlation across countries. Hence, the competitive situation across countries should remain relatively stable and the need for cross-border cooperation would be less urgent.

The ESRB is an important step towards more effective macroprudential policies in Europe.

But such an assessment would underestimate the challenge posed by the externalities described above and the political pressure exerted by national interests, even when macroprudential conditions are similar across countries. Each country assessing the situation from its own perspective would internalise only a part of the stability benefits of macroprudential tightening while alone bearing the costs in terms of reduced competitiveness of the financial services industry. It is highly likely that this would lead to a first-mover problem, where no country is willing to take the lead to tighten its macroprudential policy unless it knows that others are committed to doing the same. As a result, global macroprudential policies could become stuck in an overly expansionary stance.

European Systemic Risk Board

At the centre of the European answer to such cross-border externalities lies the European Systemic Risk Board (ESRB). This body, outlined in the de Larosière report and still in the process of being fine-tuned in the European decision-making structures, represents an important step towards more coherent and effective macroprudential policies at the European level. The mere fact there exists a European body with the explicit task of monitoring and analysing systemic risks will constitute an important improvement.

Yet it remains unclear to what extent the ESRB will be able to translate its observations on systemic risk into effective macroprudential action. This is not due so much to the ESRB lacking effective tools. In fact, its power to make recommendations to individual supervisors, the requirement for the supervisors to 'act or explain', and the threat of public naming and shaming in case of inaction (and the prospect of leaks at any point of the process) together constitute, in principle, a fairly strong set of tools.

The main risk to effective European macroprudential policies is probably more subtle. The ESRB's toolbox, by and large, consists of different ways to intervene in matters that are under the direct responsibility of national supervisors. This entails a high risk of institutional conflicts that is likely to hamper the ESRB's ability to contribute to effective macroprudential policies.

The potential for conflict is easy to see. Suppose a national supervisor receives a recommendation from the ESRB to adjust some supervisory parameters. What message does such a recommendation carry? Essentially, it communicates that the national supervisor has failed to do its job properly and that risks in the financial system under its supervision are higher than the supervisor has indicated. Besides being difficult to accept from the viewpoint of institutional prestige, such a message could be potentially destabilising for the recipient country's financial system. In practice, the response of any national supervisor would very likely be defensive rather than constructive.

Such institutional conflicts would be highly embarrassing for all parties, and hence practices would evolve to avoid taking matters that far. Formal recommendations would be preceded by informal contacts and negotiations, and what would eventually find its way into the formal recommendation would be a compromise between the ESRB and the recipient supervisor. This would not necessarily render the recommendations useless, but they would scarcely be strong enough to form the basis of timely and strong European macroprudential policies. There is a tangible risk that the recommendations would be watered-down, politically steered compromises.

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Even within its presently envisaged toolbox, the ESRB may have ways to alleviate this risk. Instead of triggering institutional conflict by singling out individual supervisors as the recipient of its recommendations, it could seek to focus its attention on genuinely European systemic risks and limit its recommendations to measures taken at European level. This could be done either by addressing an identical recommendation to each individual national supervisor, or through a recommendation addressed to the EU as a whole through the Council of Ministers. Either way, the recommendation would not question the competence of an individual national actor, and the risk of institutional conflict would therefore be smaller.

Still, such an arrangement would not necessarily ensure timely implementation of ESRB recommendations. Although collective recommendations would largely remove the stigma related to individually targeted recommendations, the first-mover problem described above would remain. Creating sufficient political momentum in support of a coordinated implementation of the ESRB's recommendation could prove challenging and cause delays in implementation. This would be particularly true if the recommendation were seen to be unpopular, such as a tightening move amidst an economic boom.

European macroprudential framework – how can we combine effectiveness and political feasibility?

The particular institutional design of the ESRB was not reached by accident. It was developed as a carefully crafted compromise between European and national interests. Yet, as a compromise, it falls short of optimal: giving several policy bodies authority over the same instrument is a recipe for institutional conflict and stalemate.

Realism dictates that possible adjustments to the ESRB's mandate must respect the ultimate authority of national supervisors over the financial system under their supervision. This political imperative will remain at least as long as the fiscal cost of financial crises falls on national governments – a situation which is likely to persist in the foreseeable future. But even within this political constraint there may still be room for improving the institutional setup so as to give the ESRB a better chance to succeed.

Overlapping competencies breed institutional conflict and ineffectiveness. So the key is to reduce such overlap. A simple way to achieve this would be as follows. Whatever the macroprudential instrument (or instruments) of choice eventually decided upon, the system would be divided into two components: a European component and a national component. The ESRB would be granted *direct authority to adjust the European component of the macroprudential instrument(s)*. Correspondingly, *national supervisors would retain full authority to adjust the national component*. The ESRB would not issue recommendations on any national component, although conceivably it could express opinions if it considers the matter important for European financial stability. Hence, the ESRB's authority would not interfere with the competence of national authorities, instead being parallel to and independent of it.

Chart illustrates this idea. The left side of the chart presents the situation as currently envisaged: the ESRB instructs national supervisors, while the latter have the formal legal authority and take the actual decisions.

The right side presents the alternative approach described above. The ESRB has direct authority to adjust a European macroprudential instrument. On the basis of its macroprudential analysis, it takes a decision on the appropriate stance for European macroprudential policy, and the decision takes effect in all European countries without any further actions required at national level.

National supervisors still retain undiminished authority to adjust supervisory parameters within their respective jurisdictions. There would, in principle, be nothing to prevent a national supervisor from adjusting the national component so as to completely offset any changes made by the ESRB to the European component.

Why would the latter model be more conducive to effective macroprudential policies? There are several reasons.

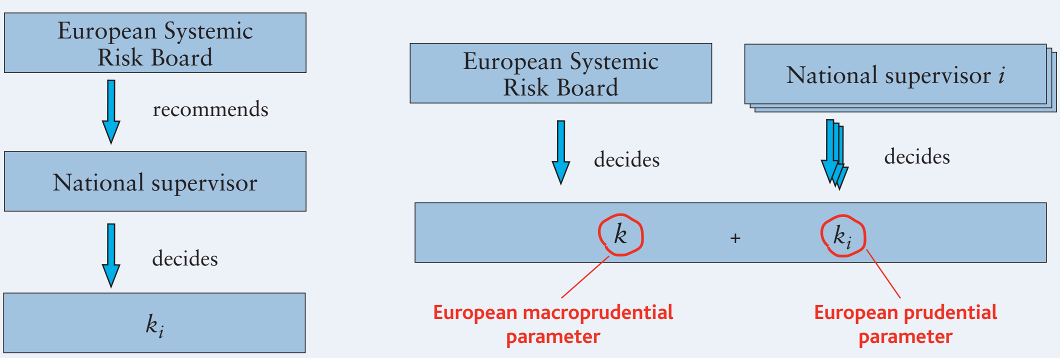
Firstly, a clean separation of European and national competences would avoid the risk of stigma and institutional conflict. A decision by the ESRB to adjust European supervisory parameters would not constitute criticism of the performance of an individual national supervisor. Instead, it would reflect the ESRB's assessment of broad developments in systemic risk in the European and global financial markets. Hence, national supervisors would be less likely to feel honour-bound or duty-bound to dispute the ESRB's analysis.

Secondly, it would alleviate the problem of regulatory capture. Under the currently envisaged system, the ESRB provides advice, but it is the national supervisor that will have to take the final macroprudential decision. Hence, it is the national

A clean separation of European and national competences would avoid the risk of institutional conflict.

Chart.

Two frameworks for macroprudential policy



supervisor that will have to explain and justify the decision to the financial institutions under its supervision, and those institutions may hold a very different view on the needs of the situation. To the extent the national supervisor is captive to the interest of the institutions under its supervision, this will contribute to making the supervisor less likely to act timely and effectively.

If, in contrast, the ESRB is granted direct authority to adjust European macroprudential parameters, its decisions will take force without any explicit action by the national supervisor. It will be the ESRB's responsibility to explain and justify macroprudential actions. The national supervisor can sit on the sidelines and has a better chance to deflect any criticism. Undoubtedly, a seriously captive supervisor could still come under pressure to take, at the national level, measures to offset the ESRB's action. Nevertheless, the power of the status quo would make the national supervisor less prone to yield to pressure.

Thirdly, and just as importantly, the model of parallel authority would remove the first-mover problem and thereby provide a better chance for peer pressure to work at European level. To be sure, peer pressure would still be needed in various European fora (supervisors, the EFC, Ecofin) to ensure that no national supervisor take actions that would undermine the effectiveness of the ESRB's policy.

Why would peer pressure work better in such a model? Because peer pressure by its very nature is a tool for enforcing conformity and is therefore far more effective in *maintaining the status quo* than in effecting change. Effective peer pressure requires that there exist a sufficient number of peers occupying the moral or political high ground (conforming position) from which to apply pressure. When no player has yet implemented an intended policy action, there is nobody to exert credible peer pressure on a potential first mover. The power of conformity works against change rather than for it.

The model proposed here turns this logic around. The ESRB's power arises from *its ability to redefine the status quo*. By its own macroprudential policy action, without any need to persuade or pressure other parties, the ESRB can move the whole system to the new desired equilibrium. Once in the new equilibrium, peer pressure can concentrate on what it is better equipped to do – maintaining the status quo (conformity) rather than changing it.

The model described above does not deprive the national supervisors of any fundamental powers they currently hold. Each national supervisor would still maintain full authority to define, within the confines of EU law, all regulatory parameters faced by financial institutions under its supervision. Yet, by rearranging the decision-making structure to avoid obvious points of conflict and to provide a better chance for peer pressure mechanisms to work, the model would offer a stronger basis for effective European macroprudential policies.

Conclusion

The recent financial crisis raised expectations regarding macroprudential policies. The extent to which regulators and policymakers will be able to meet these expectations remains to be seen. Work on macroprudential policies is currently proceeding on several parallel tracks. On one track, work is ongoing to reduce the pro-cyclical elements of capital regulation. On another track, efforts are being made to improve the availability of information on systemic interconnections.

The discussion above concentrates on a third track, one that may be the most ambitious of all, namely, the creation of a framework for active, discretionary macroprudential policies that adjust some prudential parameters to counteract excesses in financial developments. It remains to be seen whether such a new policy framework will ultimately come into existence. The development of macroprudential instruments is still at an early stage and a consensus on which instruments might be effective is not likely to emerge any time soon.

The model proposed here is agnostic about the choice of macroprudential instrument and focuses on the institutional aspects of European macroeconomic policies. This is an important part of the development effort, since even if consensus can be found on the appropriate instrument(s), there remain considerable challenges in using it (them) in an effective manner.

It is instructive to contrast active macroprudential policies with, say, monetary policy. Measurement of the extent of systemic risk will always be more complicated than measurement of the price level, and hence macroprudential policies are likely to be more controversial, and backed by less convincing evidence, than is the case with monetary policy. Yet it is important to set ambitions at a realistic level and push forward with the effort. Even an imperfect macroprudential policy is likely to be superior to no macroprudential policy at all. Active macroprudential policies will not eliminate the procyclical nature of financial intermediation, but they can be a useful addition to the set of policy tools that include monetary policy, microprudential supervision and better regulation with a clearer systemic orientation.

In terms of European macroprudential institutions, the ESRB constitutes a substantial step forward. Yet it is not clear that the way the ESRB is presently envisaged to interact with national authorities will enable it to operate effectively enough to meet the raised expectations. In particular, the fact that the ESRB has no direct authority and that implementation relies on cooperation by national supervisors may well become an obstacle to effective policy. Institutional pride, national interests, regulatory captivity and coordination problems may easily interfere.

With the recent crisis fresh in our memories, there may still be a window of opportunity to provide the ESRB with more effective instruments. Although political reality dictates that national supervisors must retain the final authority over supervisory parameters within their jurisdiction, a simple rearrangement – a separation – of national competencies and European competencies might provide tangible benefits.

Keywords: macroprudential supervision, monetary policy, European Systemic Risk Board

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