

Lessons learned from the financial crisis: Paths towards macro-prudential supervision and regulation and the role of the ECB and the ESCB

**23rd Annual Conference of the Group of Banking Supervisors from
Central and Eastern Europe (BSCEE)**

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*The views addressed in this presentation are my own,
and do not necessarily represent the official views of the European Central Bank*

Outline

- **Learning from the crisis**
- **What is macro-prudential supervision and regulation?**
- **A new supervisory framework for the EU**
- **The ESRB: tasks, structure and policy instruments**
- **Elements of a macro-prudential policy framework**
- **Conclusions**

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Learning from the crisis

Weaknesses of the pre-crisis financial system

- **Gaps in the regulatory framework**
- **Distorted incentives inside the financial system, such as short-term remuneration schemes**
- **An insufficient resilience of the financial system**
- **An institutional design of financial supervision that did not properly reflect the cross-border dimension of crises, and**
- **A lack of awareness of systemic risk**

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What is macro-prudential supervision and regulation?

“An old idea whose time has come”

- **The origins: concerns over international lending in the late 1970s**
- **BIS (1970): Systemic or system-wide orientation of regulatory and supervisory frameworks and their link to macro economy**
- **In the course of the years the macro-prudential perspective slowly gained further ground, until the current financial crisis gave it an extraordinary boost**

What is macro-prudential supervision and regulation?

Supplement to traditional regulatory approaches

- **Macro-prudential policy focuses on the interaction between financial institutions, markets, infrastructure and the wider economy**
- **It complements the micro-prudential focus on the risk position of individual institutions**
- **Neither type of policy is a substitute for sound risk management in the private sector**
- **Central banks' comparative advantages of information and action**

What is macro-prudential supervision and regulation?

Systemic risk

- **Systemic risk versus vulnerability of individual institutions**
- **Systemic role of an institution and regulation**
- **Vagueness of definitions of systemic risk**
- **Common sense by IMF, FSB, BIS: A risk of disruption to financial services that is caused by an impairment of all or parts of the financial system and with the potential to have serious negative consequences for the real economy**

What is macro-prudential supervision and regulation?

‘Systemic importance’ of institutions

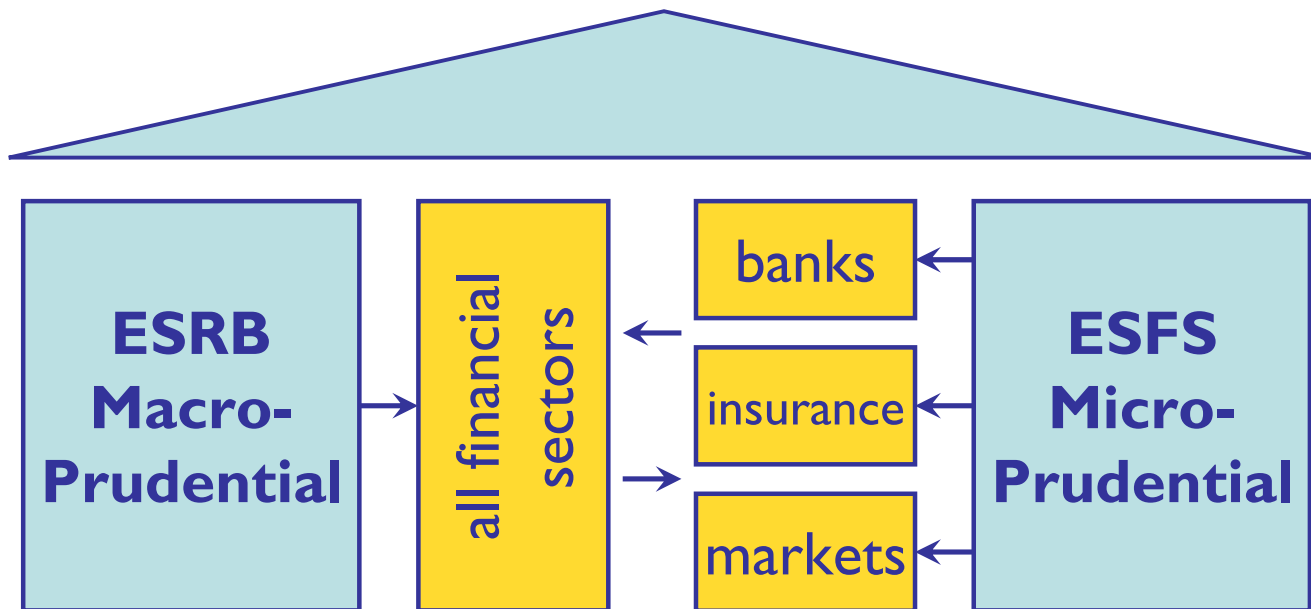
- **Challenge of definition and identification**
- **Which entities and factors?**
- **Size is only one factor; markets, infrastructure, interconnectedness further factors**
- **Development of methods for identification of systemic relevance**

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A new supervisory framework in the EU

New EU architecture based on two pillars



- Main objectives:**
- **Macro:** better oversight of systemic risk
 - **Micro:** enhanced supervisory convergence and coordination

Source: Dierick/Mikkonen (2010)

European System of Financial Supervisors

- **National supervisors remain responsible for the day-to-day supervision of financial institutions and form the European System of Financial Supervisors**
- **Level 3 Committees (CEBS, CESR and CEIOPS) will become European Supervisory Authorities (ESAs):**



European System of Financial Supervisors

ESAs - Main tasks

- **Advising the European Commission or developing non-binding guidelines**
- **Issuance of binding decisions in various areas:**
 - **Developing technical standards**
 - **Settling disagreements**
 - **Ensuring compliance with EU law**
 - **Taking action in emergency situations**
- **Planned to start on 1 January 2011**

European System of Financial Supervisors

ESFS - Main value added

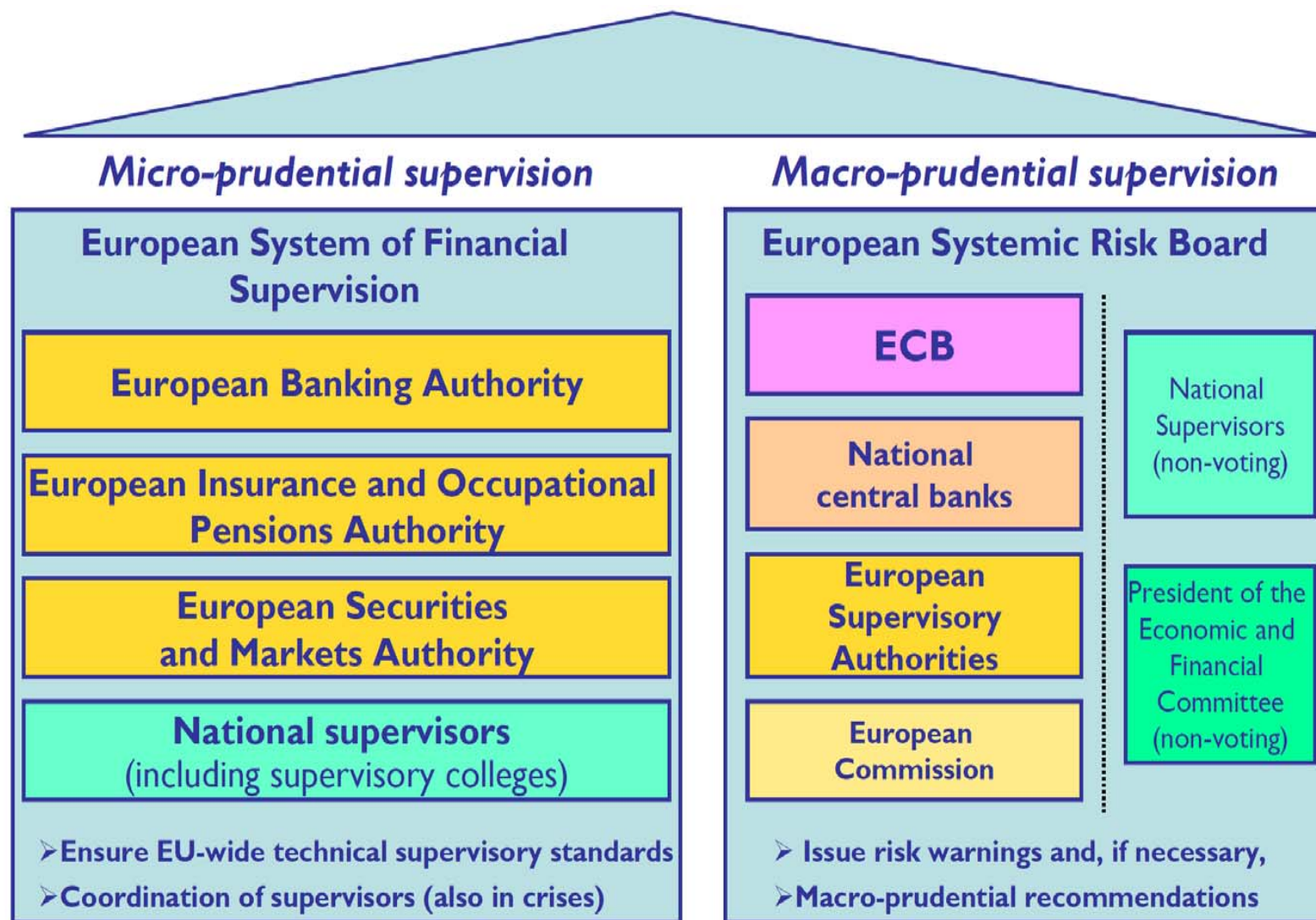
- **Ensuring a single set of harmonised rules through binding (and non-binding) technical standards**
- **Ensuring consistent application of EU rules**
- **Settlement of disagreements**
- **Establishment of a central EU supervisory database, maintained by the ESAs**

European System of Financial Supervisors

ESFS - Challenges

- **Division of supervisory responsibilities between the EU and the national authorities**
- **Burden sharing in case of cross-border crisis in financial markets**
- **Role of the Commission towards the ESA**
- **Extent to which supervisory information will be available to the ESAs and subsequently to the ESRB**

New supervisory framework in the EU



Source: Papademos (2010)

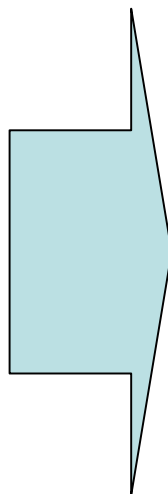
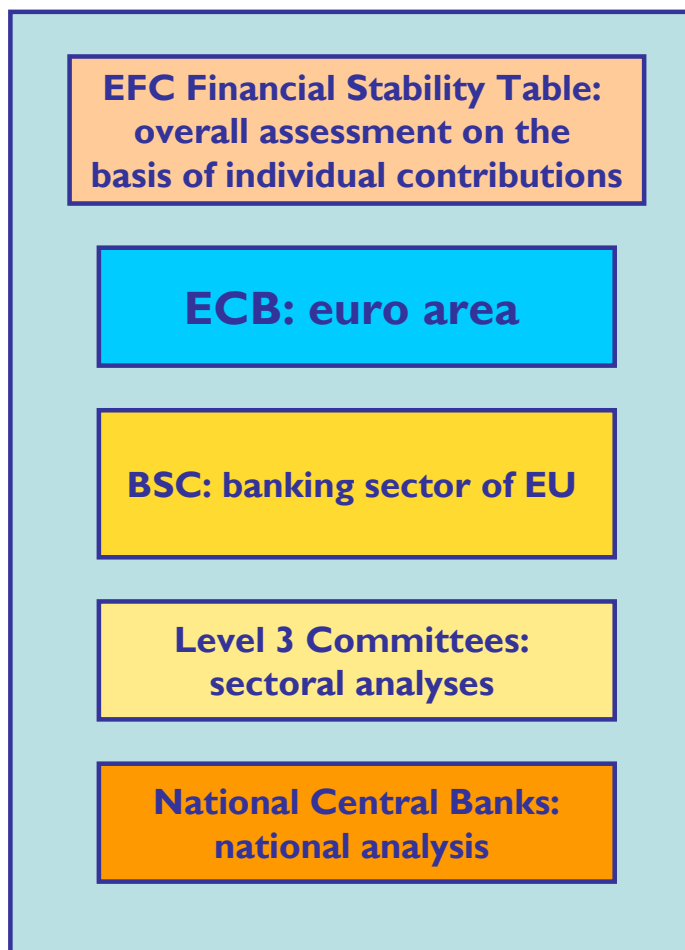
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European Systemic Risk Board

Current: Segmented EU financial stability monitoring and analysis

ESRB: Integrated EU financial stability monitoring and analysis



Source: Dierick/Mikkonen (2010)

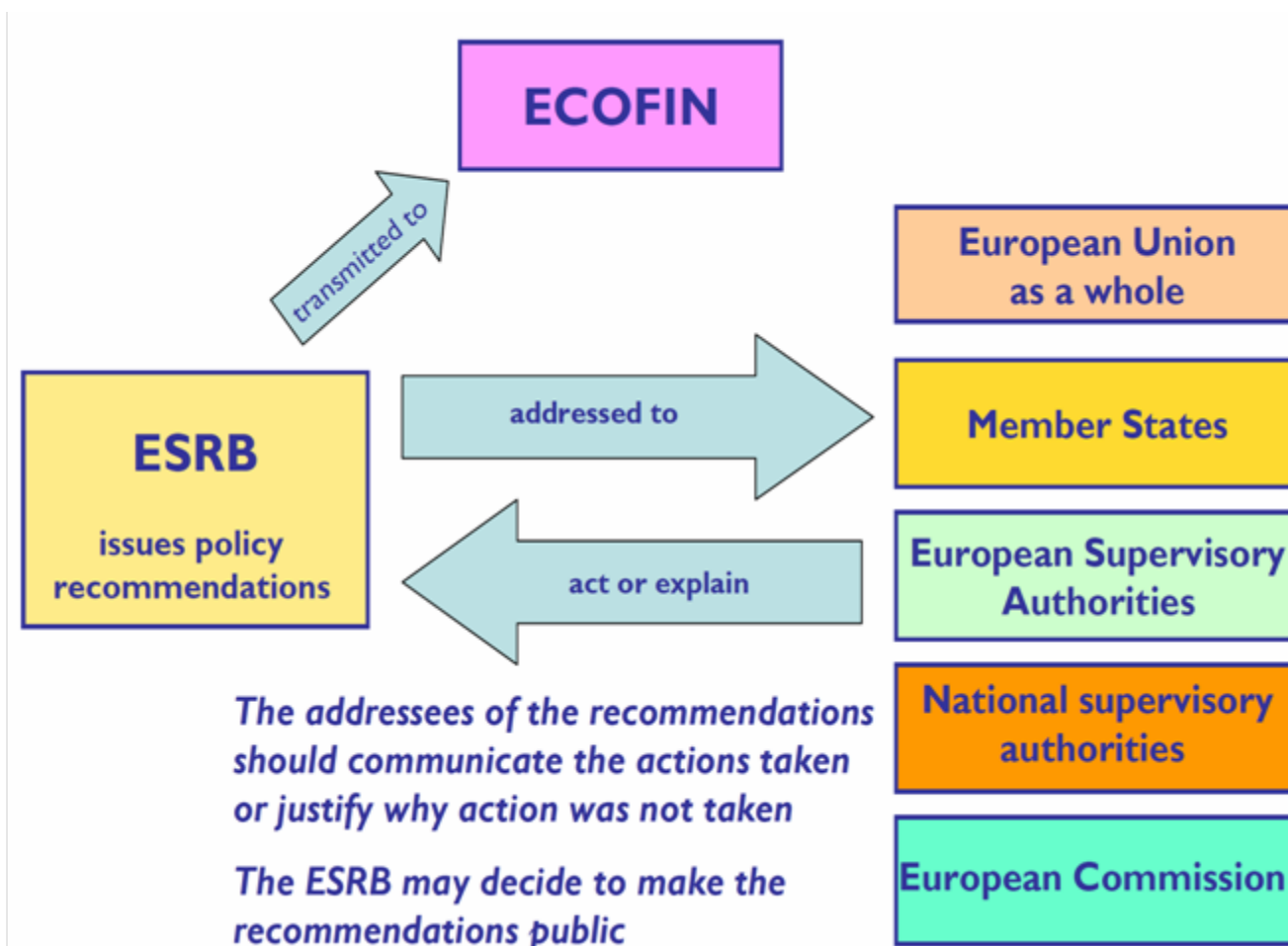
European Systemic Risk Board

ESRB - Tasks

- **Collecting all relevant information for the assessment of systemic risk**
- **Identification and prioritisation of systemic risks in the EU**
- **Issuance of risk warnings when systemic risks are significant**
- **Issuance of recommendations to contain the identified risks**
- **Monitoring of follow-up to warnings and recommendations**
- **International coordination with IMF, FSB and other**

European Systemic Risk Board

ESRB – Procedure for recommendations



Source: Papademos (2010)

European Systemic Risk Board

ESRB - Main value added

- **Integrated financial stability assessment at EU level covering the whole financial sector**
- **Enhancement of the quality of the financial stability assessment at the EU level**
- **Transformation of financial stability assessments into risk warnings and policy recommendations**

European Systemic Risk Board

ESRB - Challenges

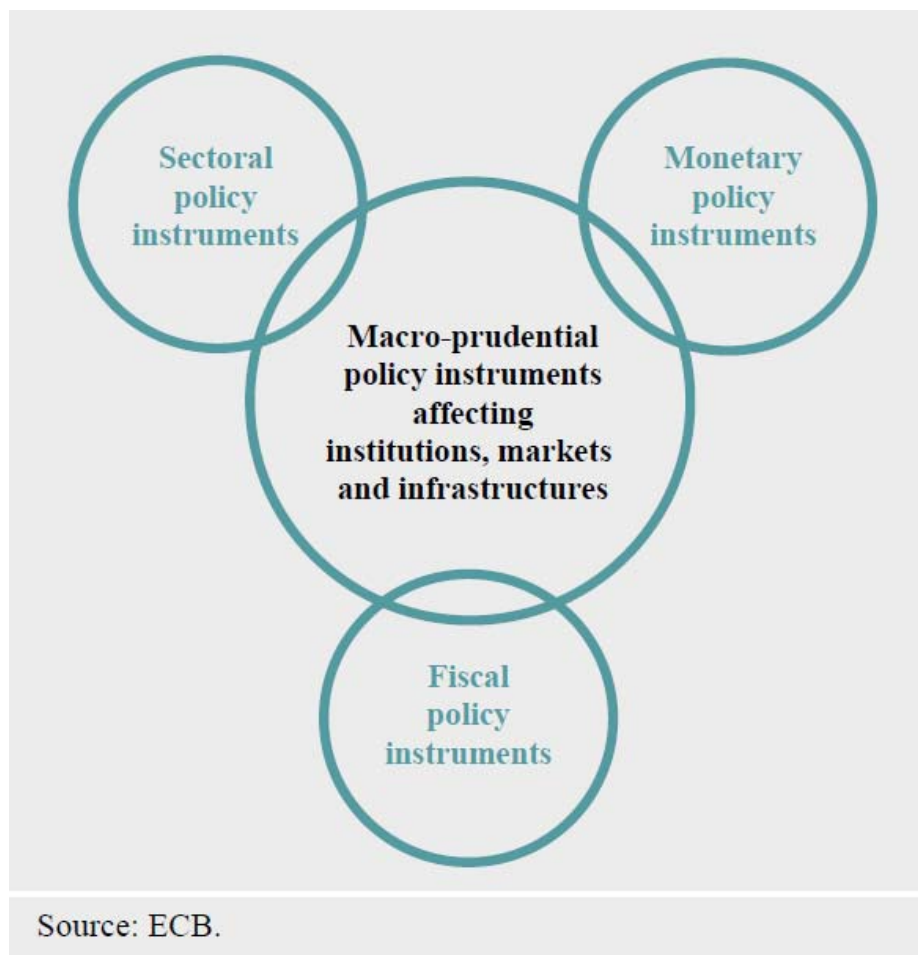
- **Macro-prudential analytics and diagnostics are still at an early stage of development**
- **No fully developed conceptual framework for macro-prudential supervision (compared with monetary policy)**
- **Division of labour between central banks, supervisory authorities and**
- **Access to relevant information and data**
- **Non-binding nature of recommendations**

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Elements of a macro-prudential policy framework

Interaction with other policy areas



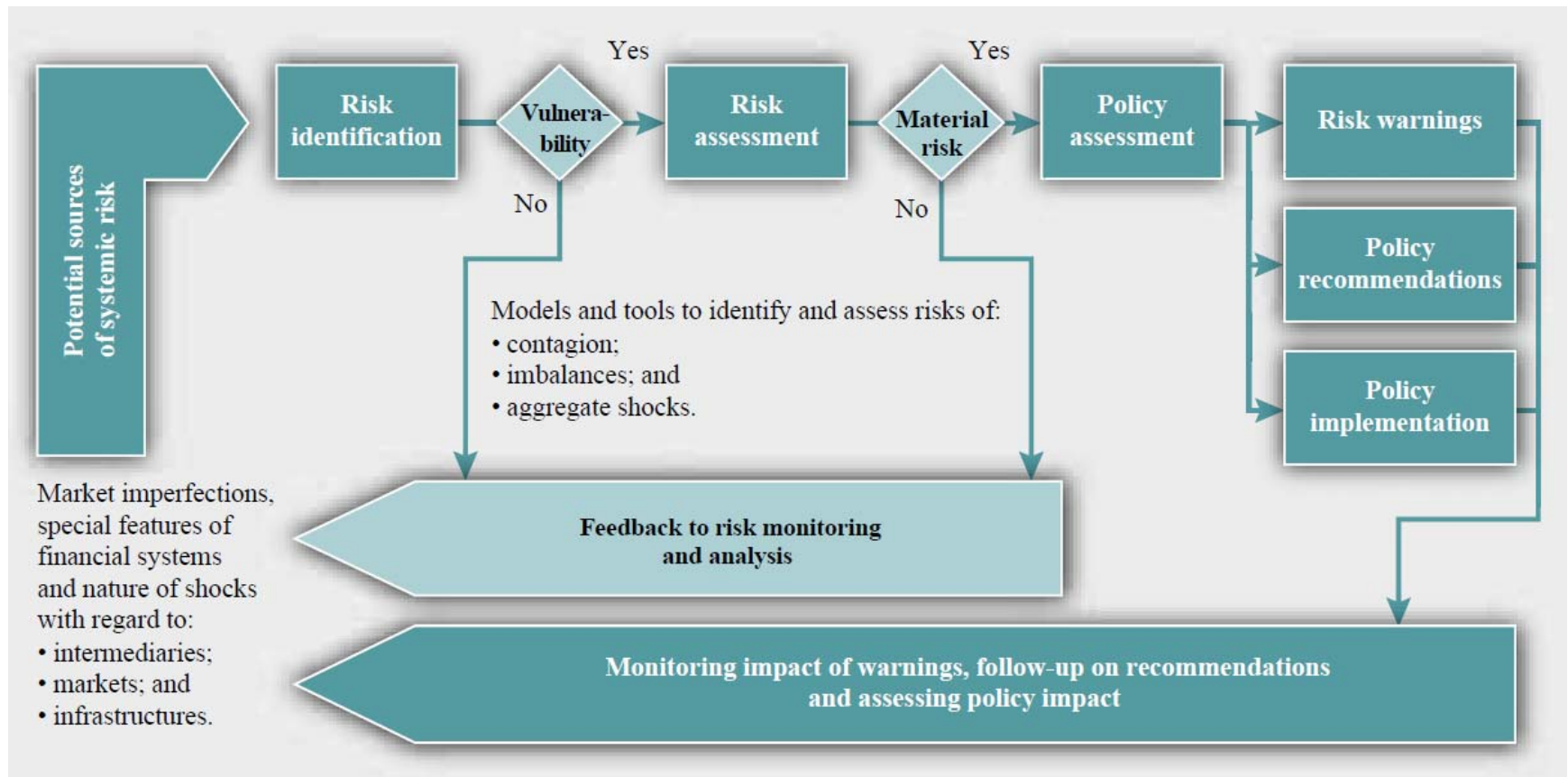
Elements of a macro-prudential policy framework

Tools for macro-prudential analysis

- **Financial stability and systemic risk indicators**
- **Early warning indicators models**
- **Stress testing models**
- **Contagion and network analysis**

Elements of a macro-prudential policy framework

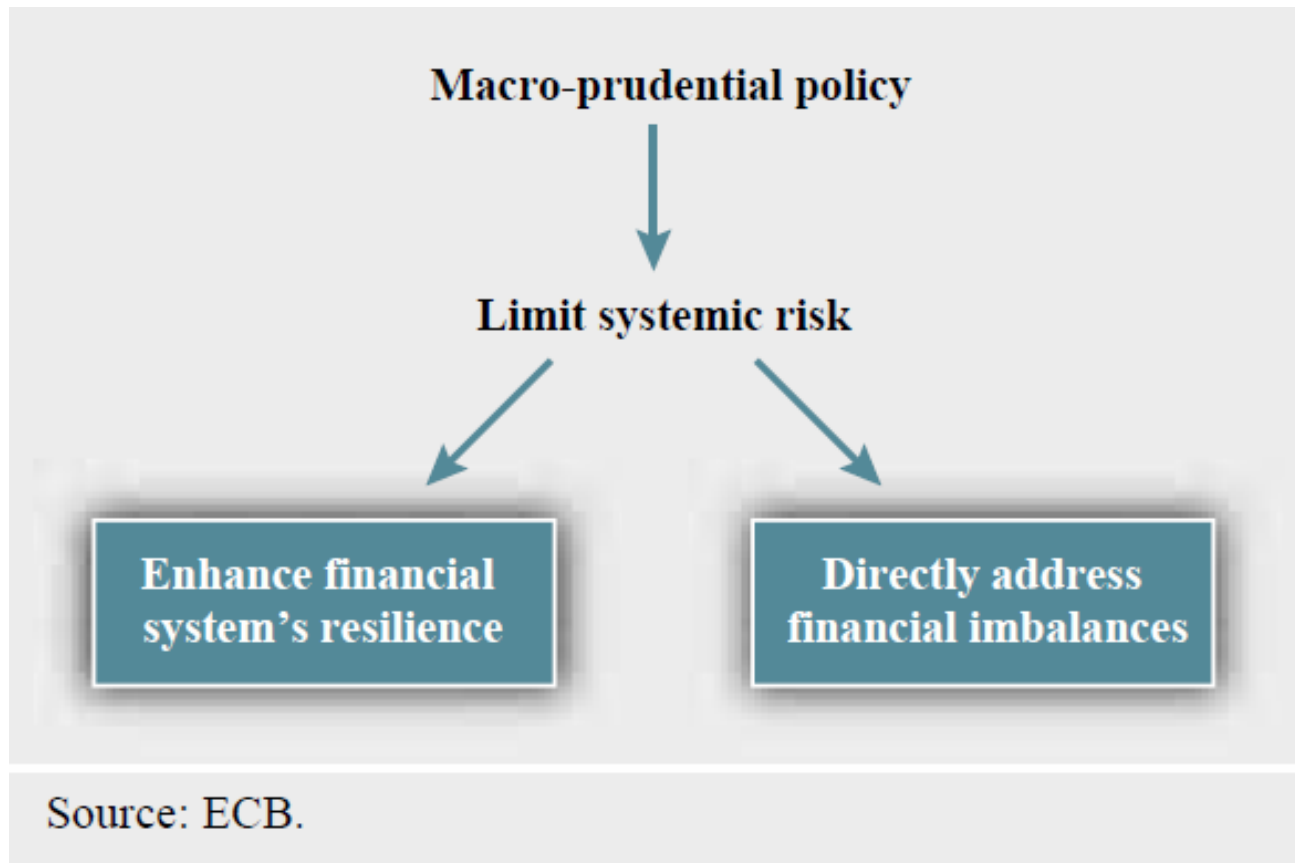
Role of analytical tools and models



Source: ECB.

Elements of a macro-prudential policy framework

Objectives of macro-prudential policy



Elements of a macro-prudential policy framework

Policy instruments to enhance system-wide resilience

| Proposed measures on capital and provisioning | |
|--|---|
| Addressing cross-sectional dimension of systemic risk | |
| Definition of capital | Tighten eligibility criteria for capital instruments classified as Tier 1 capital |
| Leverage ratio | Introduce minimum ratio of (high quality) capital over a measure of total exposure |
| Counterparty credit risk | Strengthen capital requirements for counterparty credit risk exposures (e.g. from derivatives, repos, securities financing) |
| Addressing time-dimension of systemic risk | |
| Minimum capital requirements | Reduce cyclical of minimum capital requirements (e.g. by adjusting probabilities of default in good times) |
| Capital conservation buffer | Build-up buffer above the minimum that can be drawn down in periods of stress; (maintenance of the buffer could require restrictions on dividend payments, share buy-backs or staff bonus payments) |
| Countercyclical capital buffer | Adjust capital conservation buffer on the basis of signs of excessive credit growth; accumulation and release phase of the buffer would be conditioned on (macro) variables |
| Forward-looking provisioning | Move from the current “incurred loss” approach towards provisioning on the basis of expected losses |
| Proposed measures on liquidity | |
| Addressing cross-sectional dimension of systemic risk | |
| Net stable funding ratio (long-term) | Introduce structural ratio to address liquidity mismatches and provide incentives for banks to use stable sources to fund their activities over a one-year horizon |
| Liquidity coverage ratio (short-term) | Promote short-term resilience (over 30 days) to potential liquidity disruptions: ensure that high-quality liquid assets are sufficient to withstand a stressed funding scenario |

Source: ECB (2010)

Elements of a macro-prudential policy framework

Policy instruments to address imbalances

| Aiming at affecting credit demand | | |
|---|--|---|
| Property markets | Time-varying LTV (and LTI) ratios | LTVs (LTIs) lowered in periods of overheated property markets, relaxed in downturns, possibly coupled with other borrower eligibility criteria |
| Credit to corporates | Collateral rules on secured lending | Tighter collateral rules in credit extended to sectors showing excessive credit growth, or in which system-wide vulnerabilities were detected |
| Corporates (active in securities markets) | Time-varying margins or haircuts on secured financial transactions | Increased margins or haircuts on secured financial transactions in booms and relaxed in downturns |
| Aiming at affecting the credit supply | | |
| Property markets | Specific and discretionary capital surcharges | Capital surcharges focused on main exogenous sources of risk such as LTV-based capital-ratio risk weights |
| Credit to corporates | Specific and discretionary capital surcharges | Capital surcharges focused on main exogenous sources of risk such as adjusted risk weights on exposures to specific borrowing sectors or borrower classes |
| Securities markets | Time-varying margins or haircuts on secured financial transactions | Increased margins or haircuts on secured financial transactions in overheated periods, relaxed in downturns |

Source: ECB (2010)

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Conclusions

Essential to structure incentives in a stability-oriented manner

- **Primary objective of the current reforms is to strengthen the resilience of individual institutions as well as the financial system**
- **Important not to further increase complexity of regulations**
- **Focus on ensuring that microeconomic incentives are structured in a stability-oriented manner**
- **Should help to minimise risk of further financial crises entailing high macroeconomic costs**

Sources

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Thank you for your attention!

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