

# Ensuring adequate macro-prudential supervision in the EU

Giovanni Carosio  
**Banca d'Italia**

Conference "Towards a new supervisory architecture in Europe"  
Bruxelles, 7<sup>th</sup> May, 2009

# Contents

- ✓ **Lessons from the crisis**
  
- ✓ **Towards a macroprudential approach to supervision:**
  1. Analysis
  2. Policy tools
  3. Institutional architecture

# Lessons from the crisis

**1. Banks' behaviour:** excessive, often unaware, risk taking in a period of over-optimism and financial euphoria, also determined by:

- lax credit standards
- the complexity of new financial instruments and their lack of transparency
- overestimation of diversification benefits from securitization
- underestimation of liquidity risks
- problems of governance in financial firms and myopic remuneration schemes
- excessive reliance on market discipline and uncritical trust in rating agencies' assessments

# Lessons from the crisis

## 2. Weaknesses in the regulatory and supervisory framework:

- Basel I rules gave incentives to shift risk off balance sheet and to create a shadow banking system
- Basel II standards may entail procyclical effects
- new accounting rules also highly cyclical
- inadequate supervision in some countries
- unsatisfactory existing arrangements for the supervision of large cross-border intermediaries
- **regulation and supervision focused on micro-stability: externalities have been largely neglected**

# Is a macroprudential approach the answer?

## 3 ingredients are needed for a proper use of a (more) macro-oriented supervision in the EU:

- **Analyses**: Are financial stability analyses tailored for policy use?
- **Tools**: What tools are available for implementing macroprudential supervision?
- **Institutional architecture**: Which financial architecture is most suitable for the proper functioning of micro and macroprudential supervision?

# Macroprudential analysis

- Notwithstanding the advances of financial stability forecasting, the framework has not yet reached a steady-state
  - crisis was largely unexpected
  - while analyses have been sometimes able to identify precise early signals of risks, they have often provided more cloudy information
  - the macroprudential assessments were often too wide-ranging, giving little guidance for policy actions
  - for supervisors to adopt countermeasures on the basis of warnings about possible (but still uncertain) problems requires some kind of criterion to weight different scenarios
- Stress tests are an important component of the financial stability toolkit and should be strengthened and more widely used
  - if understood and used correctly, they may improve the awareness of policy makers on new risk factors, making the adoption of countermeasures more timely and effective
  - but not panacea, supervisory soft information also crucial

# Macroprudential analysis

## **A first step towards a more policy-oriented framework is to integrate top-down with bottom-up assessments**

- CEBS has recently started a two-way risk assessment process:
  - flowing from an EU-wide macroprudential analysis of market developments and related vulnerabilities for the financial system ...
  - ... to the analysis of risks at individual cross-border groups undertaken by supervisory colleges, and vice-versa
- This process needs to be strengthened:
  - the macroprudential analysis should be carried out by a centralized unit with adequate analytical capabilities and access to supervisory information
  - national supervisors should be required to respond to this analysis by stating their own views and priorities for action, taking into account local market specificities
  - two-way interaction with colleges should be made more systematic: need to ensure that the bottom-up detection of risks is fed into the macro analysis and that colleges use this analysis to identify appropriate mitigating action

# Policy tools

## Tools are needed to turn the analysis of risks into action

- We need both macroprudential tools, i.e. tools that apply to the whole banking system, and microprudential tools, to ensure that the specific exposure to common risk factors of individual institutions is properly taken into account.
- As for macroprudential tools, the most important objective to be achieved is that regulation should be less-cyclical, ideally countercyclical

# Macroprudential tools

## Tools to dampen procyclicality

- Consensus that banks should be required to build up buffers of financial resources in expansionary phases and be allowed to run-down them when things go wrong ...
- ... but lively debate on how buffers should be designed
  - various proposals under discussion: some aim at adjusting Basel 2 capital requirements in order to take explicitly into account a mixture of macroprudential risk factors (balance sheet expansion, degree of leverage, CDS spreads, equity prices, etc.)
  - most of them face analytical challenges and might prove quite difficult to implement in practice.

# Macroprudential tools

## CEBS work on cyclicality

- CEBS has also put forward a proposal for a countercyclical Pillar 2 buffer, based on scaling-factors to be applied to PDs
- Introduction of a simple rescaling mechanism that takes into account the historical changes in PDs estimated by banks in recession
  - Pillar 2 capital buffer is determined as the difference between the amount of capital computed using the current PDs and the one computed using re-scaled PDs
  - Possible alternative based on (automatic) time-varying confidence levels
- Not a substitute for stress tests run by banks, but a benchmark that EU supervisors would use as part of the “supervisory review process”
- Banks would be expected to “comply or explain” should their internal stress tests deliver results that appear excessively mild with respect to supervisors’ expectations

# Macroprudential tools

## Which characteristics should the ideal countercyclical tool have?

- **Rule-based** The use of basically automatic mechanisms:
  - implies that no discretion is required from supervisors (less room for policy errors)
  - does not require continuous justification and can act as an effective pre-commitment
  - can relieve pressure on the supervisors not to take action during the expansion
- **Incentive-compatible.** Less prudent banks should be penalized more than more conservative ones and no room for regulatory arbitrage should be left. This implies the tools should be:
  - calibrated to individual banks' portfolios
  - based on risk-sensitive measures
- **Pillar 2 implementation:**
  - allows for flexibility in testing new prudential tools (particularly if rule-based)
  - would preserve the informative content of minimum regulatory capital on current risk

# Macroprudential tools

- It is paramount that buffers do **not become new minimum capital levels** when conditions deteriorate, as this would have the paradoxical effect of aggravating potential procyclical pressures:
  - not only supervisors but also market participants should be prepared to accept buffers being run down in a recession
  - need for strong communication policies from supervisors
- Work on capital buffers should go hand in hand with the one regarding **accounting standards and prudential rules for provisions:**
  - the prudential framework seeks to ensure that banks are able to cover expected losses with provisions and unexpected losses with capital
  - dynamic provisions and countercyclical capital buffers may effectively complement each other and have the potential to reduce significantly boom and bust phenomena

# Institutional architecture

## **Care is needed in the practical implementation of the de Larosière proposals, in order to ensure a smooth interplay between micro- and macroprudential supervision**

- the boundary between micro- and macroprudential issues, as well as between systemic and non-systemic intermediaries, can be difficult to assess
- the process for translating macroprudential analyses into policy actions via supervisory, micro-prudential tools is crucial for producing recommendations that are shared by the authorities involved and implementable
- the mechanisms for accountability should be designed with great care, as it should always be clear who is responsible for what (especially if something goes wrong)
- the integration between top-down assessment and bottom-up evaluations, with the involvement of supervisory colleges, should be preserved and reinforced in the new institutional architecture