EUROPEAN CENTRAL BANK

EUROSYSTEM

Macro-prudential Supervision and How to Control the Risks of Systemic Financial Intermediaries

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Panel intervention at the 19th Hyman P. Minsky Conference on the State of the U.S. and World Economies "After the Crisis: Planning a New Financial Structure", New York City, 14-16 April 2010

Systemic risk

- Financial and economic crisis has made the relevance of systemic risk crystal clear
- Risk that financial instability becomes so widespread that it impairs the functioning of a financial system to the point where economic growth and welfare suffer materially
- Three main “forms” of systemic risk (Trichet 2009; De Bandt, Hartmann and Peydro 2009)
  - Contagion
  - Endogenous build-up and unravelling of widespread imbalances (Minsky)
  - Aggregate shocks
- Can involve all components of financial systems (intermediaries, markets and infrastructures) and two-way relationship with the economy at large

Hyman Minsky or the Monster of Loch Ness

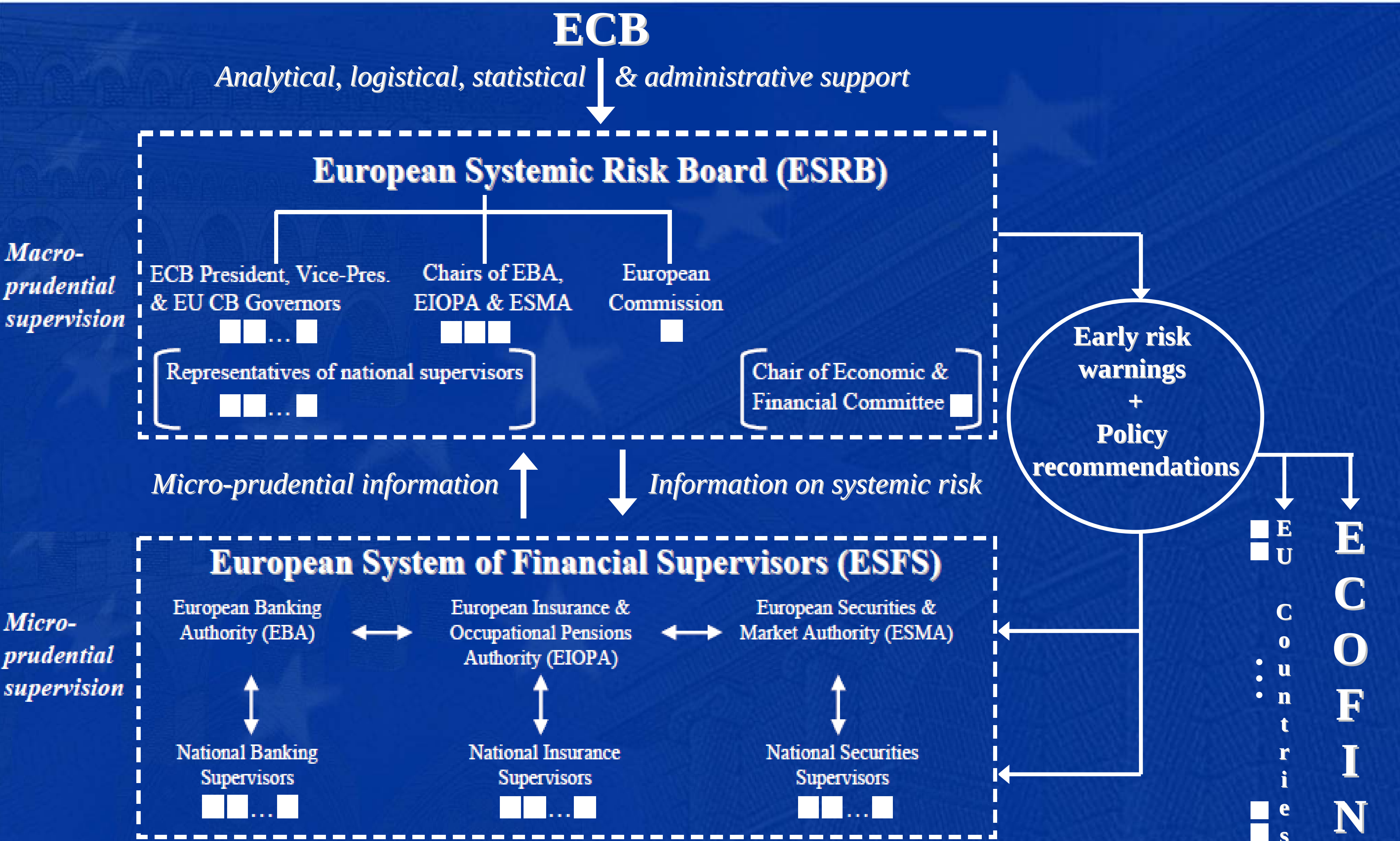
"Systemic risks are for financial market participants what Nessie, the monster of Loch Ness, is for the Scots (and not only for them): Everyone knows and is aware of the danger. Everyone can accurately describe the threat. Nessie, like systemic risk, is omnipresent, but nobody knows when and where it might strike. There is no proof that anyone has really encountered it, but there is no doubt that it exists."

Sheldon and Maurer (1998)

Broad policy approach

- Strengthen macro-prudential wing of supervision and regulation (comparative advantage of central banks)
- Macro-prudential supervision: Public oversight that aims at identifying and containing systemic risks
- Macro-prudential regulation: Public regulations that aim at maintaining systemic stability
- "New" policy area, like third macro-economic stabilisation policy (in addition to monetary and fiscal policy)
- Micro-prudential supervision: Oversight of specific intermediaries or markets
- Distinction from micro-prudential regulation by objective
- But known instruments similar in character, closely related

Proposed EU supervisory structure



Source: Author's characterisation based on EU Commission (2009a,b)

Systemic intermediaries: Standard answers

- 2X2 problems
  – X=big
  – X=complex/opaque
  – X= interconnected
  – Xs are related but not identical
- Public support in crises is fact of life, go on as before
- Improved and stricter regulation (more and better capital and liquidity buffers)
- Improved and stricter supervision (governance and compensation, risk management, stress testing etc.)
- Separation (“Volcker rule”) or ring-fencing of risky activities (subsidiaries), narrow banking

Systemic intermediaries: Innovative ideas

- Make capital/liquidity buffers dependent on X (Geneva Report, US treasury)
- Private capital insurance (Kashyap, Rajan and Stein)
- Access to pool of funds against Pigou or Tobin tax (Perrotti and Suarez, UK)
- Contingent capital
  - Convertible debt (Flannery, Dudley)
  - Compulsory equity issuance in response to CDS spreads (Hart and Zingales)
- Living wills (Squam Lake Working Group on Financial Regulation)
- Strengthen competition policy in banking (Perrotti and Suarez; Carletti, Hartmann and Ongena)

Conclusions

- Broad policy response needs to be fully developed macro-prudential approach
- 2X2 problems only subset
- Tough trade-offs regarding re-fragmentation of financial systems: Easier closure and resolution in crisis versus business efficiency, competitiveness and overall economic performance in tranquil times
  - Business lines: Narrow or separation banking
  - Scale: Limits on size
  - Geographical lines: Deviation from home country principle/national subsidiaries
- Trade-offs pronounced in Europe: Completion of single market

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Thank you for your attention!

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