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Challenges facing macroprudential authorities

P. Angelini
Banca d'Italia

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Macro-Risk Assessment and Stabilization Policies with New Early Warning Signals

In Search of a New Normal:
Macroeconomic Policies and Macro-Prudential Regulation in Unconventional Times
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1. Systemic risk, which macroprudential policies aim to minimize, is multi-faceted

Systemic crises can arise and spread within and across:

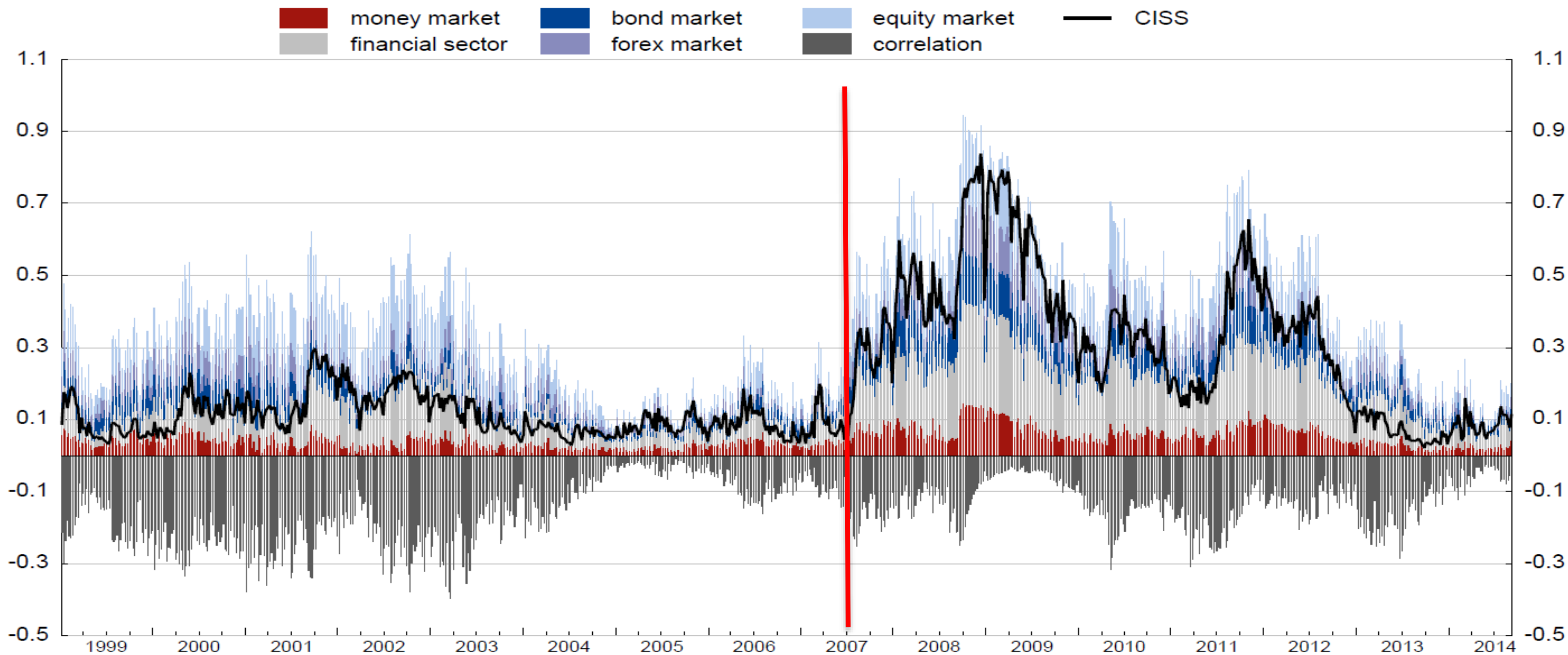
- financial institutions (e.g. a bank run; the default of an investment bank can spread to commercial banks)
- markets (e.g. a stock market crash, a currency crisis, a confidence crisis in the interbank market)
- countries/geographical areas
- market infrastructures (CCPs, wholesale payment systems, …)

2. A reliable theoretical-analytical system to understand, calibrate and measure the effectiveness of macroprudential policies is not available yet

- No model can encompass all the dimensions of systemic risk
- Some macro models typically do not incorporate the externalities that give rise to systemic risk
- Other models do feature systemic externalities but tend to be too stylized to be of practical help for policymaking

3. Systemic risk very difficult to identify ex ante. Good leading indicators enabling early activation of macroprudential policies are hard to obtain

Composite indicator of systemic stress



Source: ESRB, Risk dashboard

- Important exception: indicators based on credit growth

4. A set of macroprudential tools is emerging through practice and legislation, but outlines and properties are not yet well defined

- Some instruments are clearly spelled out and harmonized in EU rules (e.g. countercyclical capital buffer); others are left to national legislation (e.g. LTV, LTI)
- Is e.g. the capital conservation buffer a macroprudential instrument?
- A RE overheating can be fought by e.g. increasing risk weights on mortgages, or decreasing LTVs, or …
- The mutual interactions of the tools are not clear yet, although there is some evidence of their effectiveness

5. In Europe, additional challenges arise from the complex architecture of the system of financial supervision

- Recent changes – the establishment of National macroprudential authorities and the start of the Single Supervisory Mechanism – further complicate the picture

The European System of Financial Supervision
(as launched in Dec 2011; subsequent innovations are in bold)

	Micro-prudential	Macro-prudential
European level	European Banking Authority (EBA)	European Systemic Risk Board (ESRB) • EBA • ESMA • EIOPA • EU Commission • President ATC • President and Vice-President ASC • Non EZ NCBs • EZ NCBs • ECB *Without voting right*: • President Economic and Financial Committee • NCAs on supervision of insurance and pension funds • NCAs on markets supervision • NCAs on bank supervision, non-EZ countries • NCAs on banks, EZ countries
	European Securities and Markets Authority (ESMA)	
	European Insurance and Occupational Pensions Authority (EIOPA)	
	Joint Committee of the three European Supervisory Authorities	
Eurozone level	**Single Supervisory Mechanism (SSM)**	
National level	National micro-supervision authorities	**National macro-prudential authorities (NMAPs)**

6. Little is known about interactions btw macroprudential policy and other policies – e.g. microprudential

- In the next 3-5 years several factors will affect capital requirements:
  1. Phase-in of Basel 3 (largely done)
  2. Phase-in of buffers (G-SII, O-SII, systemic risk); activation of countercyclical capital buffer
  3. Ongoing work of Basel Committee (revision of trading book; of IRB models & standard method; of AMA models)
  4. Phase-in of TLAC, MREL
  5. Leverage ratio
  6. Phase-in of IFRS 9 (impact on provisioning)
  7. OND harmonization (SSM)

6. Little is known about interactions btw macroprudential policy and other policies – e.g. microprudential (2)

- Each of the above regulatory drivers of banks' capital requirements has a strong rationale
- Overall, they will tend to increase <u>level</u> of requirements, as well as <u>uncertainty</u> about level
- What is the appropriate level of bank capital?
  - Higher k <u>levels</u> associated with more lending
  - <u>Increases</u> in k requirements associated with less lending
  - Bank capitalization has increased dramatically
  - Supervision is not just about raising capital requirements
- Assessment of policies (micro+macro) need to be all-encompassing. Fallacy-of-composition effects were the main motivation for the introduction of macro-prudential framework. Such effects must be avoided

Summing up

- Emphasis on challenges is not meant to belittle enormous progress achieved since the start of the crisis
- A pause (in regulatory change, institutional change, …) is probably necessary; some adjustment still needed, but difficult to motivate <u>radical</u> amendments of current framework without allowing a full phase-in of the framework itself
- In spite of remaining areas of uncertainty, the new macroprudential policies have strong potential to contribute, together with micro and monetary policy, to a more stable macrofinancial system

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