Financial Resilience and Systemic Risk

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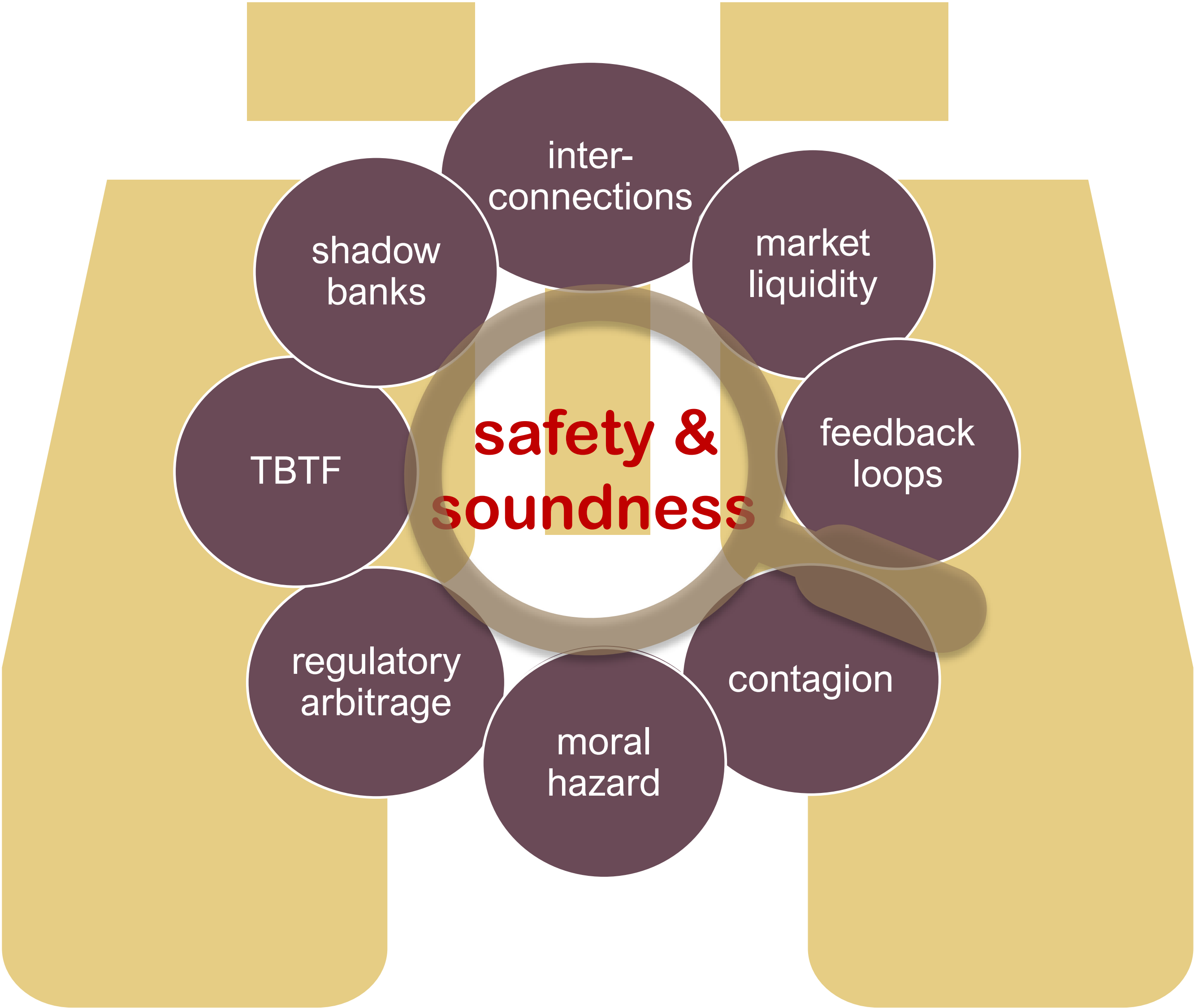
The Architecture of Financial Stability Policy: Unfinished Agenda

Dimitri Demekas

Visiting Senior Fellow, IGA, and Special Adviser, Bank of England*

(*) The views in this presentation are the author's and do not represent those of the Bank of England.

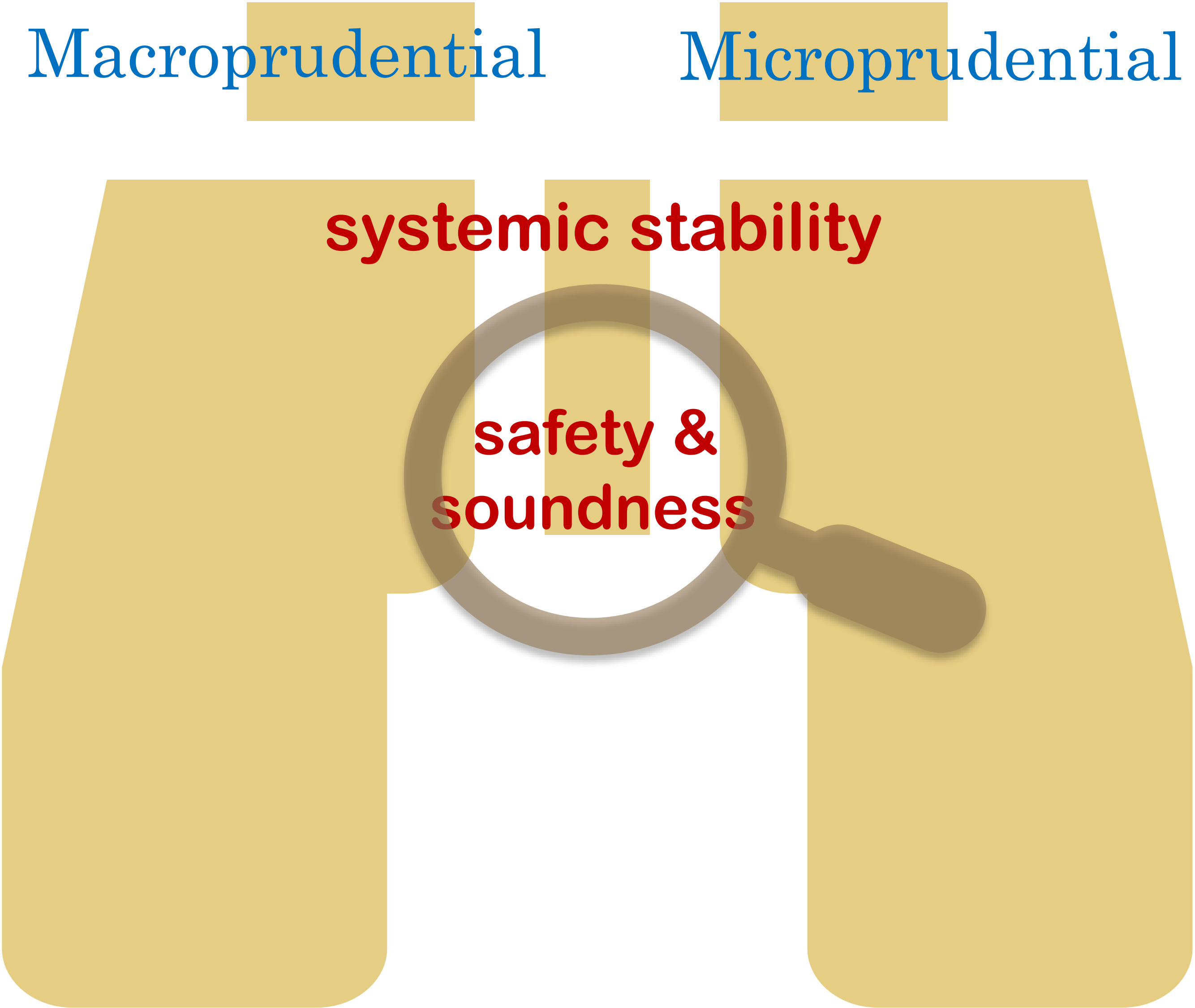
Widening the field of vision



“[A] critical question for regulators and supervisors is what their appropriate "field of vision" should be. Under our current system of safety-and-soundness regulation, supervisors often focus on the financial conditions of individual institutions in isolation. An alternative approach […] would broaden the mandate of regulators and supervisors to encompass consideration of potential systemic risks”

Bernanke (2008)

Widening the field of vision



"In the pursuit of financial stability, we should strive for a better marriage between the microprudential and macroprudential dimensions of the task".

Crockett (2000)

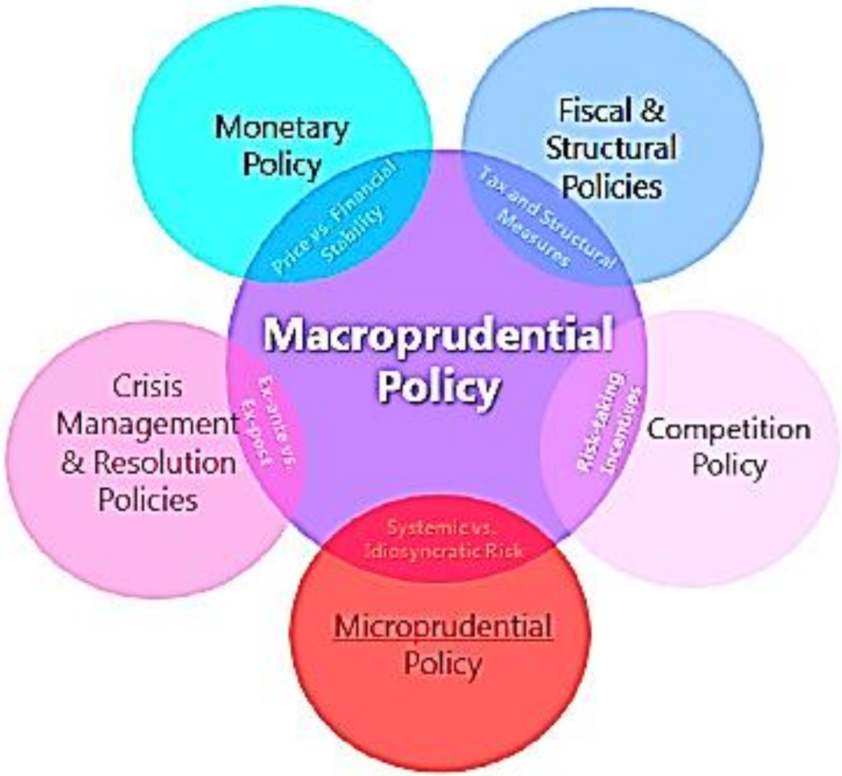
From an ‘additional dimension’ of prudential policy…

“We need to be realistic about what macroprudential tools can and cannot accomplish. […] The word macroprudential is becoming very popular, and we run the risk of using “macroprudential” as a catch-all term to cover all manner of policies. I think we should be careful. [B]road definitions unnecessarily widen the objective to be pursued by supervisors and lessen accountability. […] Confusion about a policy may undermine its effectiveness”.

Caruana (2010)

…to a central position among policies!

Figure 1. Relationship between Macroprudential and Other Policies



Source: IMF staff.

IMF (2013)

"The global financial crisis highlighted the need for dedicated macroprudential policy"

IMF-FSB-BIS (2016)

Macroprudential policy can 'provide guidance', 'demand more forceful action,' and 'correct biases' in prudential regulation, bank resolution, and monetary, tax, competition, and housing policies.

IMF (2013)

A few things to consider:

Macroprudential policy

- The policy goal (financial stability) is not well-defined
- The operational target (systemic risk) is non-observable
- There are trade-offs between financial stability and growth (and social preferences are neither well defined nor stable)
- Uncertain link between policy tools and outcomes
- Substantial redistributive implications

"Too much of the ongoing debate relates to details and technical features [while] much less attention has been paid to viewing the subject [of financial stability] top down and examining how the various difficult areas hang together"

Sir Andrew Large (2015)

Unfinished business

Shift the focus from macropru to financial stability

- Define goal and risk tolerance
- Establish boundaries
- Introduce proper governance arrangements

Financial stability policy: goal

Yardstick for measuring success, setting risk tolerance, ensuring accountability

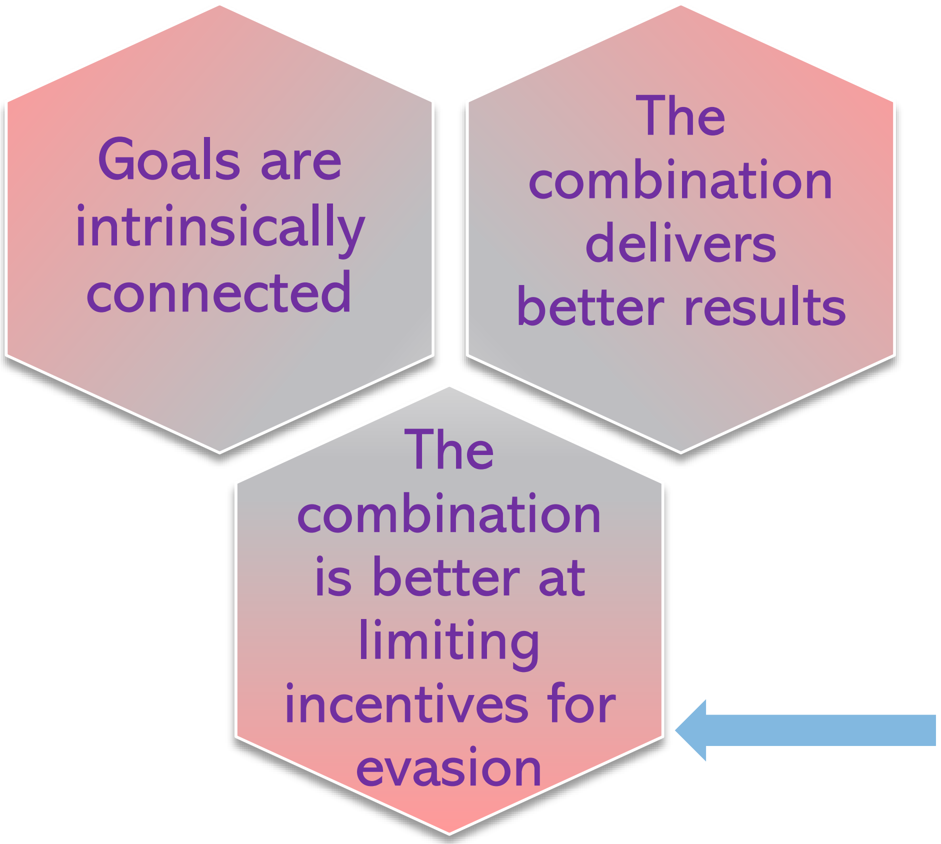
- Practical way #1: agree on a model-based measure of systemic risk, define risk tolerance, stress test, repeat
- Practical way #2: establish a *process* of challenging the decisions of financial stability authority, forcing it to explain its rationale, and act upon the comments

  'Discursive accountability' (Gehring 2004)
- Practical way #3: ?...

Financial stability policy: boundaries

Which policies/tools should come under the ambit of financial stability policy?

Criteria:

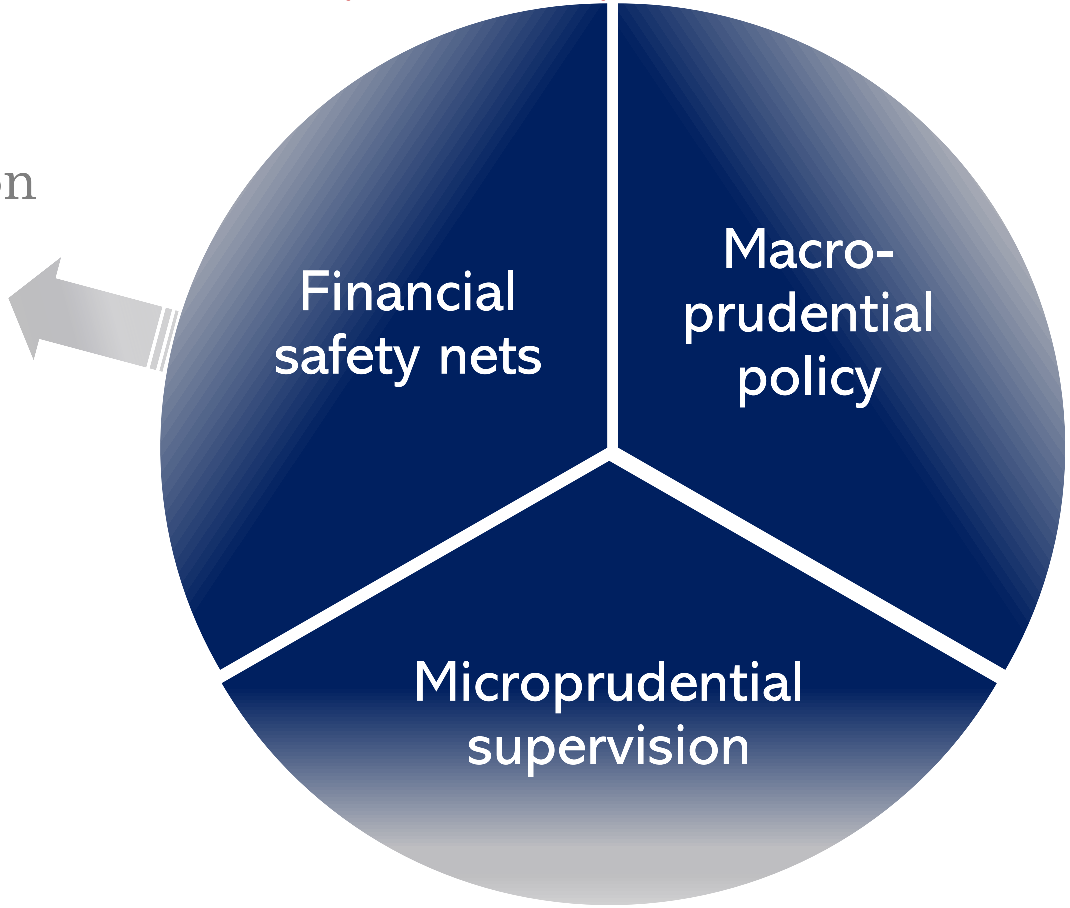


Financial stability as a ‘common good’ (Tucker 2018)

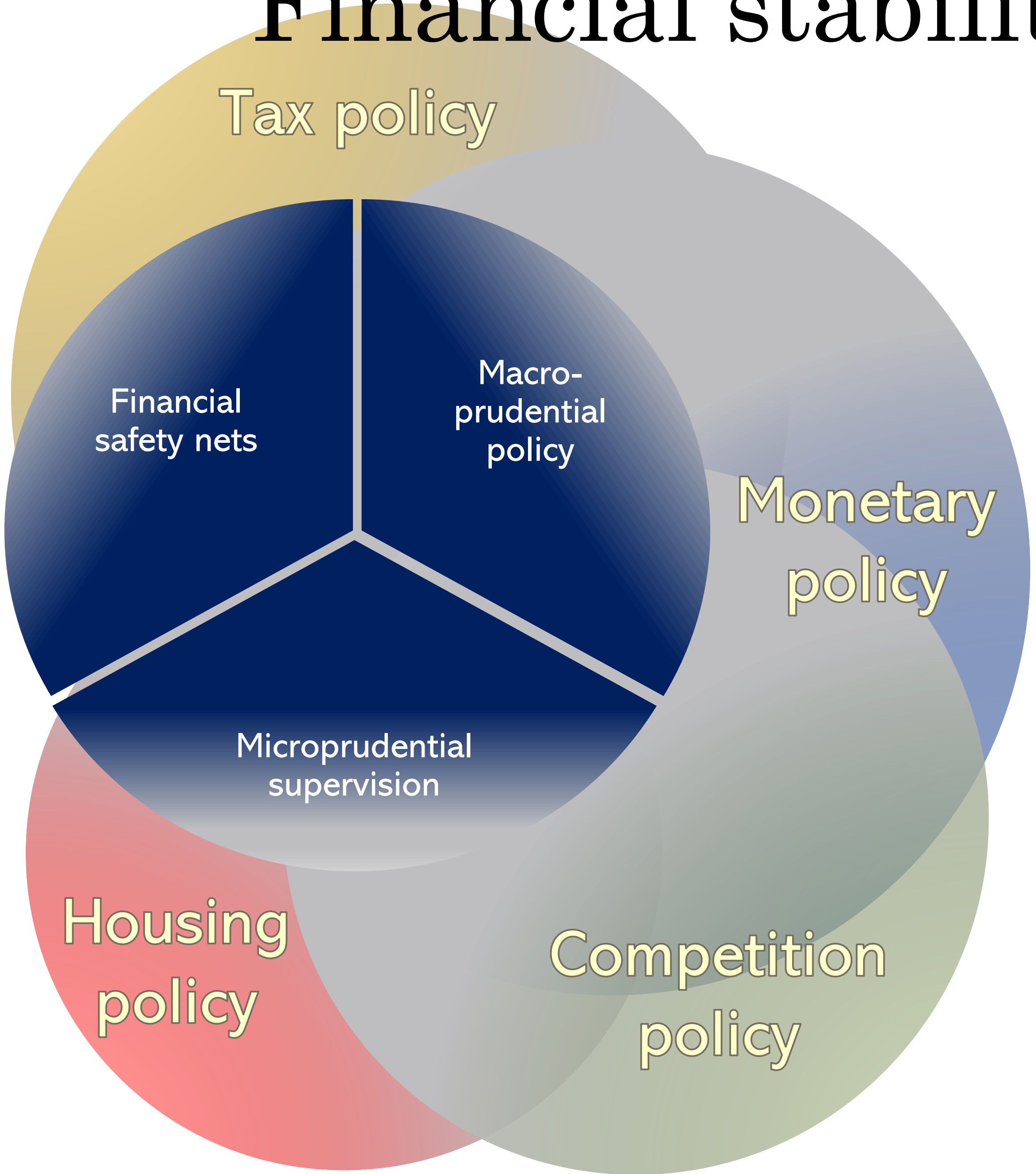
Financial stability policy: boundaries

Which policies/tools should come under the ambit of financial stability policy?

structural rules
recovery & resolution
deposit insurance
ELA/LOLR
crisis management



Financial stability policy: boundaries



Monetary policy ('leaning against the wind') can mitigate FS risks *BUT*

- only in some states of the world
- at substantially higher economic cost than macroprudential measures, both *now* and *in the future*

Ajello et al. (2016); Svensson (2017); Fell & Fahr (2017); Aikman et al. (2018); IMF (2015)

Financial stability policy: governance

Default option

Assign responsibility for FS to central bank (preferably) or to separate council (with CB playing a leading role), give them “independence”

Is the default option appropriate?

Alesina-Tabellini
‘Principles of Delegation’

Alesina & Tabellini
(2007, 2008)

- Goal (criteria of success) can be specified ex ante ✗
- Social preferences (risk tolerance) are stable ✗
- Time inconsistency is an issue ✓
- There are no serious redistributive consequences ✗

Financial stability policy: governance

An Integrated Financial Stability Policy Framework				
Aspect	**Decision level**	**Policy component**		
		Macroprudential policy	*Microprudential supervision*	*Financial safety nets*
Design	**Political**	Definition of financial stability objective, risk appetite, perimeter Institutional architecture and delegation framework: agency responsibilities, mandates, and powers; scope of resolution framework; scope of deposit insurance Arrangements for inter-agency coordination and conflict resolution Agency monitoring and accountability		
Prerequisites	**Political and technical (agency)**	Operational and budgetary autonomy of relevant agencies Legal protection of supervisors/agency officers Human and technical capacity; resource allocation		
Analytics	**Technical (agency)**	Systemic risk assessment System-wide stress tests, spillovers, contagion, Market monitoring Data gaps	Supervisory risk assessment Capital & liquidity assessment for supervised firms Operational and other risks Data gaps	Analysis of liquidity needs for ELA/liquidity insurance Contingency planning, crisis simulations ('war games') Assessment of DI reserves Data gaps
Operations	**Technical (agency)**	Macroprudential tool design and calibration Designation of systemically important firms Communication with industry and public, FSR	Supervisory approach On- and off-site inspections, benchmarking, etc. Compliance assessment, corrective action framework Group/conglomerate oversight	Implementation of structural reforms Normal and emergency liquidity operations Resolvability

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