Macroprudential policy: Too complex, too late, too weak?

Isabel Schnabel
University of Bonn and Advisory Scientific Committee of the ESRB

Fourth ESRB Annual Conference
Frankfurt, 27 September 2019
Paradigm shift in banking regulation

- Important shift of perspective from individual institutions to the system as a whole, taking into account macroeconomic repercussions from correlated individual bank behavior.

- In practice:
  - Additional regulatory instruments on top of microprudential regulation: cross-sectional & cyclical.
  - New supervisory structure on top of existing microprudential supervisory authorities: national & supranational.
Main issues with macroprudential policies in a nutshell

1. Operationalization of systemic risk
2. Complexity of regulation and illusion of control
3. Inaction bias
4. Relationship with monetary policy
5. Leakage and regulatory arbitrage
1. Operationalization of systemic risk

- No fully convincing operational measure of systemic risk
- Measures showed low level of systemic risk shortly before crises
- Lack of granular data
- Need for narrative approaches (Shiller, 2017)?
2. Complexity of regulation and illusion of control

- Adding macroprudential regulation has increased the complexity of regulation and of the supervisory architecture.

- Excessive complexity may raise systemic risk:
  - Illusion of a well-controlled system
  - Incentives to game the system
  - Danger of missing unknown contingencies
  - Unknown interactions between various instruments
  - Incentives to shift risks out of the regulatory perimeter.
3. Inaction bias

- Activation of **cyclical macroprudential tools** is likely to be **delayed**:
  - Difficulty to identify the financial cycle in real time
  - Political influence: Electoral cycles (Müller, 2019)
  - Influence by lobbyists
  - Reluctance of microprudential supervisors to tighten regulation in good times, reluctance of SSM to impose top-up
  - Further decision and implementation lags

- Example: **Countercyclical capital buffer**
  - Guided discretion has worked poorly: credit-to-GDP gap is not a reliable indicator of the financial cycle and its prominence has delayed activation

- More automaticity in the build-up of capital buffers? Positive “normal” level of CCyB?
4. Relationship with monetary policy

- Q&A Mario Draghi, 12 September 2019: “... to many of these side effects [of monetary policy] the answer is not to change monetary policy but rather implement specific macroprudential policies...”

- Is macroprudential policy strong enough to counter a monetary policy that encourages higher bank lending and risk-taking?

- Institutional impediment:
  - In the euro area, the SSM could top up national macroprudential measures
  - But in the ECB’s mandate, there is a clear priority of price stability over financial stability
5. Leakage and regulatory arbitrage

- Cross-border and cross-sectoral spillovers may give rise to additional systemic risks and may hamper the effectiveness of macroprudential policies
- Cross-border spillovers may imply a need for international cooperation
  - Reciprocity as one useful tool
- Cross-sectoral spillovers call for macroprudential policies beyond banking
  - Shift towards more activity-based regulation?
- But: Danger of further raising regulatory complexity
Some tentative conclusions

- Paradigm shift towards a macroprudential perspective is crucial

- Too complex
  - Illusion of control even more dangerous than in microprudential regulation
  - Robust measures preferable to excessive fine-tuning
  - Importance of “narratives” to discover the build-up of systemic risk

- Too late
  - Inaction bias limits the effectiveness of cyclical macroprudential tools

- Too weak
  - Macroprudential policy too weak to counter monetary policy
  - Need for international cooperation and macroprudential policies beyond banking