EPFSF Briefing

"How to manage systemic risk?"

Summary

There is a clear rationale for the management of systemic risk, and effective macro-prudential oversight should contribute to ensuring a sustainable supply of credit to the economy to support growth and avoid asset bubbles. It will be important for individual countries to have a macro-prudential authority with the capacity and flexibility to vary prudential, structural and other regulatory requirements to underpin the resilience of their local financial systems. However, given the close integration of global capital markets, the high risks of spillovers and regulatory arbitrage, it is important to consider also the pan-European, international and global aspects of macro-prudential policymaking.

It will be necessary to ensure that there are suitably robust yet informed and flexible mechanisms to assess and decide when and how macro-prudential tools should be deployed or adjusted. The resolvability of firms and linkages with the crisis management framework should also be a key area of focus and the management of systemic risk will need to be balanced and coordinated with other policies that can have a bearing on financial stability, including monetary policy.

Introduction

Systemic risk can develop and crystallise rapidly - it is often unpredictable, dynamic and evolving. It involves multiple parts of the financial system and its crystallisation usually takes different forms with far reaching and sometimes global consequences.

Identifying and monitoring the sources and transmission mechanisms of systemic risk is a key public policy priority. Mitigating systemic risk – by applying the regulatory tool kit proportionately across the financial system – is more important still. Successful monitoring and mitigation of systemic risk is likely to involve the provision of meaningful data for regulators, across the widest breadth of jurisdictions.

Definition and Causes of Systemic Risk

There is no single definition of systemic risk. The Joint FSB-IMF-BIS definition of systemic risk[1] is *'a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy'.*

The causes of the 2008 financial crisis are often attributed to global macro-economic imbalances which led to a rapid growth in global liquidity and falls in real risk-free interest rates in many economies. Prior to the crisis policy was not focussed on controlling the volume of credit as it expanded and drove economic growth to unsustainable levels, including the over-inflation of prices in some asset classes.

There are also cross-sectional or structural types of systemic risk (correlation and/or concentration risks) which relate to connections between firms and the distribution of risk within a sector. These can exacerbate both the upswing and severity of the downturn. For example, when a given amount of similar risk is concentrated in a small number of institutions or markets, or when the provision of financial services is highly concentrated, the system is likely to be more vulnerable than if risks and the provision of services were more evenly distributed. By way of illustration, the Spanish Cajas - although individually small - had collectively a significant exposure to the same sector - property.

[1]FSB-IMF-BIS Report to the G-20 Finance Ministers and Central Bank Governors, October 2009

Systemic risk can also be generated and/or amplified by the opacity and complexity of institutions, markets and instruments. These factors can lead to increased uncertainty, potentially driving perception-driven contagion contributing to a breakdown of market functioning - making institutions more difficult to resolve.

Systemic risks include therefore those that are attributable to *'unsustainable levels of leverage, debt or credit growth'*, to *'the distribution of risk within the financial sector'* and to *'structural features of financial markets, such as connections between financial institutions'*. Macro-prudential policy is designed to increase the resilience of the financial system through the identification, monitoring and mitigation of systemic risks; the aim is to prevent the crystallisation of these risks from causing instability in the financial sector and the real economy.

Responsibilities for Managing Systemic Risk in Europe

At a European level, the European Systemic Risk Board ('ESRB') is tasked with identifying and monitoring systemic risk and recommending the deployment of macro-prudential policy tools to mitigate such risks. The ESRB was formed in December 2010 and has a legal responsibility for systemic oversight and the prevention and mitigation of systemic risks to the EU financial system. However, the ESRB has not to date had the power to use macro-prudential tools directly; its role involves issuing warnings where systemic risks are deemed to be significant and issuing recommendations for remedial action.

The ESRB has issued recommendations also on core elements of national macro-prudential mandates which include the recommendations that central banks should play a leading role, and that there should be appropriate coordination mechanisms with other authorities and a consistent set of policy tools. However, given the close integration of global capital markets, the high risks of spill-overs and regulatory arbitrage, it is important also to consider the international and global aspects of macro-prudential policymaking, including the proportionality of deploying macro-prudential tools across the different sectors of the financial services industry.

Many EU countries are currently in the process of drawing-up national institutional frameworks for macro-prudential policy – for example: in Germany the Bundesbank has been designated the macro-prudential authority and a Financial Stability Committee has been created which consists of representatives from the Bundesbank, the Ministry of Finance and BaFin; while in the UK the Financial Policy Committee is tasked with identifying, monitoring and taking action to remove or reduce systemic risks with a view to protecting and enhancing the resilience of the financial system. In France, le Conseil de stabilité financière is being formed and the Banque de France will be given an explicit financial stability mandate. Central banks in Belgium and the Czech Republic have also been tasked with maintaining financial stability in their jurisdictions.

There are, in addition, clear risks to economic growth from the unilateral application of capital or other requirements to firms from or within a particular country, not least from the negative spillover effects the use of such tools might have on industries in different jurisdictions and at different points in the economic cycle.

The challenge for the EU authorities is to develop a framework which offers clarity on which authority (or authorities) has competence at each level of the macro-prudential policy process. This is a vital element of the Banking Union package. Clearly, within the Single Supervisory Mechanism (SSM) there may be a case for mixed competence for some levels, such as analysis or the formulation of recommendations. By contrast, there should be ultimate levels of authority (i.e. national or Eurozone/banking union level) which hold veto power over macro-prudential policy decisions.

Systemic Risk: - Selection of macro-prudential tools

There is a yet no widely agreed and comprehensive theoretical framework for the selection and calibration of macro-prudential policy tools and it is too early to be able to provide a definitive assessment of which, amongst a range of potential macro-prudential tools will prove to be the most effective.

In practice, macro-prudential policy tools often take the form of micro-prudential instruments that are used for systemic purposes. In banking, some of the core measures that are currently being considered by regulators and legislators comprise: enhanced prudential requirements for systemically important financial institutions ('SIFIs'); counter-cyclical capital buffers; variable liquidity requirements; counter-party credit requirements including mandatory margining; and the use of the leverage ratio.

More granular tools which can enable macro-prudential supervisors to better target sources of systemic risk by allowing them to target a particular class or type of asset are also available. These include: sectoral capital requirements; the application of loan-to-value and loan-to-income limits; and the use of stress testing and adjustments to capital and liquidity requirements through the Pillar 2 framework.

Meanwhile, structural types of systemic risk can be mitigated through the use of large exposure and concentration risk limits and charges, and the use of central counterparties (although these can in themselves pose new sources of systemic risk, in particular concentration risks). Structural reform of the financial sector might also contribute towards dealing with the issue of firms which are 'too big to fail'. The design and use of trading venues can contribute to enhancing transparency and thereby increase stability, while disclosure by firms of information considered to be beneficial for reducing systemic risks (both time varying and cross-sectional) can both alleviate uncertainty and impose additional market discipline.

Within the context of the "shadow banking" debate - which considers the extent and nature of the systemic risks that could arise in or be transmitted through non-bank or market finance operations - there is a discussion about the appropriateness and impact of applying a range of the micro-prudential instruments most typically associated with banking to capital markets activities and entities. Securities markets regulators in particular advocate the value and appropriateness of the securities markets regulatory toolkit – transparency, disclosure, gating, liquidity fees etc. - in playing a role in mitigating systemic risk where it may occur in market finance activities.

Systemic Risk: - Deployment of macro-prudential tools

It will be necessary also to ensure that there are suitably robust yet informed and flexible mechanisms to assess and decide when and how a macro-prudential tool should be deployed or adjusted. It will be important that the most appropriate tool, or blend of tools, are selected. These responsibilities could be undertaken by expert macro-prudential bodies supported by appropriately skilled and resourced secretariats and analytical units within national central banks, and at the ECB and ESRB at pan-European levels. These bodies would recommend or decide at what stage of the economic cycle tools should be applied, when additional requirements should be released and at what stage firms should be able to make use of macro-prudential buffers and/or other resources. Such powers and responsibilities would of course need to be subject to arrangements for sufficient accountability and transparency.

Macro-prudential tools are likely to differ in their suitability for tackling sources of systemic risk, and their appropriateness may vary over time and according to the circumstances and the type of firm to which they are being applied, e.g. a bank vs. an asset manager or market finance entity. Effectiveness is likely, however, also to depend on the relative elasticity of response of different risks to the imposition of different macro-prudential tools including the speed and durability of an instrument's impact. In this respect it will be important that there is sufficient transparency about the nature and use of a particular tool. Accordingly, there will need to be effective channels of communication to market participants for decision making bodies to ensure there is adequate understanding about the circumstances surrounding the exercise of a tool.

It will of course be important that the effectiveness of macro-prudential tools is not limited by inadequate coverage of the population of risk-posing firms or business activities. It will be necessary to ensure that the perimeter of regulation is kept under review to ensure tools can be applied to the relevant risk posing entities and activities.

Wider Considerations and Linkages

While macro-prudential supervisors might be well positioned to identify risks emerging on a sectoral or economy-wide basis, their micro-prudential colleagues are likely to have greater insight as to the firm-specific behaviours and strategies driving the evolution of these risks.They may also to be closer to developments in relation to structural types of systemic risk and the distribution of risk within the financial sector. Accordingly, it will be very important to ensure that micro-prudential supervision is of a sufficient standard and grounded in a deep understanding of the risks in firms' business models and the surrounding systems and control environments.

Resolvability and linkages to the evolving crisis management framework should also be a key area of focus for macro and micro-prudential policy, as ensuring failure can occur without contagion should contribute significantly to guaranteeing financial stability.

Finally, there is evidence to suggest that monetary policy has an effect on risk taking by financial institutions and other market participants. While in the short term there may be occasions where there are trade-offs between interest rate policy directed at preserving price stability and financial stability, these tend to reinforce each other over the longer term. It is of course necessary that the management of systemic risk is balanced with supporting economic growth and that macro-prudential policy aims to avoid or reduce the costs of financial crises - rather than seek to remove the economic cycle in its entirety or to eliminate risk, neither of which are feasible.

Conclusion

An effective framework for managing systemic risk in Europe is likely therefore to involve a combination of sound micro- and macro- prudential supervision, clear decision-making processes and levels of authority, and a robust mechanism to deal with individual firm failure. It will need also to be balanced and coordinated with other policies that can have a bearing on financial stability, including monetary policy, to ensure that there are no conflicts between the management of systemic risk and sustainable economic growth.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Chairman, Members or Secretariat of the Financial Industry Committee.

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