Financial Stability Institute | BIS

Central banks and financial oversight

Workshop on "How do monetary, micro- and macropolicies interact?"

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Views expressed are those of the presenter and do not necessarily reflect those of the BIS.

Overview

1. Institutional design
2. Monetary policy and financial stability
3. Separating micropru and macropru?
4. How supervisory models have evolved in practice
5. A challenge for CBs' independence?
6. Word on the EMU/BU regime

1. Institutional design

- Three components:
  1. Decide which functions (monetary policy, macro-pru, micro-pru, resolution should be delegated to independent agencies (IA)
  2. Allocate functions to different agencies
  3. Establish institutional regime of each agency: (remit, governance and internal organisation, accountability etc)
- And three criteria:
  1. Aim at correcting time-inconsistency/credible commitments problem
  2. Balance between minimising conflicts between objectives and maximise synergies, but also economise institutional complexity.
  3. Ensure independence but constrain discretion to what is really needed

2. Monetary Policy and Financial Stability

Should central banks have (micro and/or macropru) responsibilities?

- Monetary Policy and prudential policies show both potential conflicts and complementarities

Conflicts	Complementarities
Forbearance	Objectives: No monetary stability without credit stability
Moral hazard	Instruments: MP (prudential) instruments with impact also on prudential (macro) developments
Reputation for central banks	ELA (which can only be provided by CBs) has a financial stability aim

2. Monetary Policy and Financial Stability (cont)

Should central banks have (micro and/or macropru) responsibilities?

- Experience broadly supports the case for assigning CBs with financial stability responsibilities:
  - The origin of supervisory organisations and central banks already recognise fundamental synergies: eg creation OCC (as part of the **National Currency Act** in 1863) or Federal Reserve in in the US in 1913 *to provide the nation with a safer, more flexible, and more stable monetary* ***and financial system***.
  - Since then, complementarities have been evident: central banks have traditionally been involved in the resolution of nearly all banking crisis. Some coordination issues when CBs did not have supervisory responsibilities.
  - No much evidence on the actual relevance of conflicts:
    - Delayed action (forbearance) also seen in non-CB regulators (eg accumulation of toxic assets in countries with different supervisory regimes).
    - Moral hazard can be caused by pure MP actions (eg Greenspan put) with or without prudential responsibilities
    - The reputation of CBs not immune to crisis even if they had no prudential functions

3. Separating micropru and macropru?

- Synergies are very important:
  - Same main overall goal: to prevent systemic crisis by increasing resilience
  - Large intersection of the tool box: capital buffers, risk weights…
  - Micropru needs always a systemic perspective: objective is not to avoid individual failures
  - Most relevant macropru tool is probably the micropru policy stance (eg minimum capital thresholds in Stress Tests or average capital add-ons in Pillar 2)
- Conflicts may arise:
  - Release of counter-cyclical capital buffer in bad times
  - Tightening macro-measures that can erode profitability

3. Separating micropru and macropru? (cont)

- But should normally be internalised: Macropru will not work as intended if banks' balance sheet are not fit-for-purpose
- Main issue: the use of non-capital based macropru tools (LTV, DSTI ceilings …)
  - Target is not resilience but containing exuberance
  - Need to be adopted also outside the banking sector
  - Subject to special social/political sensitivity
- •An institutional compromise: Macropru committees with broad representation (CBs, other supervisors, Treasuries, independentness) chaired by the CBs.

4. How supervisory models have evolved in practice?

Changes in the primary microprudential authority for banking supervision

Table 6

		Current		
	From \ To	Central bank	Separate supervisory agency	Total pre-GFC
Pre-GFC	Central bank	48	1	49
	Separate supervisory agency	5	27	32
	Government department	1	0	1
	Total current	54	28	82
		Total changes	7	

Note: changes are highlighted/shaded.

Source: Calvo et al (2018): " Financial supervisory architecture: what has changed after the crisis?", *FSI Insights on policy implementation*, no 8, April.

- Models in which CBs are the main micropru authority prevails
- This is more so after the GFC

4. How models supervisor models have evolved in practice? (cont)

Primary authority responsible for macroprudential policy

Table 13

Primary banking supervisor	Entity responsible for macroprudential policy	Recommendation only	Activation only	Recommendation and activation	Total
Central bank	Central bank	0	18	17	35
	Dedicated committee	5	0	5	10
Separate supervisory agency	Central bank	1	1	3	5
	Dedicated committee	7	1	3	11
	Separate supervisory agency	0	4	2	6
	Government department	0	2	2	4
Total		13	26	32	71

Source: Calvo et al (2018): " Financial supervisory architecture: what has changed after the crisis?", *FSI Insights on policy implementation*, no 8, April.

- Central banks are in most cases (60%) the primary macropru authority. This is particularly the case when they are also micropru authorities (80%)
- But in a noticeable number of countries the responsibility is exercised by a dedicated committee (30%)
- CBs have gained weight in the financial stability domain across the board.

5. A challenge for CB independence?

- Both, analysis and experience supports CBs involvement in financial stability.
- Challenge for independence derives from two sources:
  - Accumulation of power in non-elected officials
  - Power gains on matters of high political sensitivity (eg credit availability) and close to core government functions (eg public finance implications of crisis)
- But, the case for independence remains strong:
  - Like MP, prudential policies also subject to time-inconsistency issues and may be misguided if affected by the political cycle

5. A challenge for CB independence? (cont)

- Need of a robust delegation arrangement:
  - Separate accountability on financial stability (eg specialised committees with different but overlapping membership)
  - Transparency not only on outcomes but also on criteria and operational procedures (stress tests help)
  - Avoid further stretch the mandates adding functions (consumer protection, competition, development, innovation, financial inclusion etc) for which the time-inconsistency issue is not that relevant even if some synergies with monetary-pru policies exist.
- Main challenge is not accumulation of power but, possibly, technical difficulty to meet inflation targets, the need to increase the degree of intervention in capital markets and the required coordination with fiscal policies.

6. A word on the EMU/BU regime

- Prudential responsibilities assigned to ECB under a pragmatic application of the separation principle.
- Macropru and micropru separated (Governing Council/SSM) although coordination should be straight forward (joint forums and large intersection of membership).
- Relatively unusual separation of prudential and resolution responsibilities with overlapping functions (eg trigger for resolution)
- Main issue is remaining national responsibilities for member countries and limited macropru powers for ECB (only top-up, no LTV or DSTI)
- …and also ability by national resolution authorities to impose requirements (ring-fencing) at the domestic subsidiary level.
- Need to establish the basis for further centralisation of competences on the financial stability domain (eg strengthen public risk sharing mechanisms, complete BU)