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"A perspective of Asian Financial Sector under the Global Financial Crisis"

Session II Macro-prudential regulation and the perimeter of regulation

Macroprudential policies – rationale and taxonomy

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Abstract

This presentation reviews the key elements of a macroprudential approach to regulation and supervision. The macroprudential approach differs from the microprudential approach by an emphasis on the mitigation of systemic risk, rather than investor protection, as the overriding objective. However, macroprudential policies cannot target the system but must, like microprudential policies, work at the level of individual institutions to be effective.

Systemic risk is the risk of disruption to the provision of financial services. This has a time-dimension – macro-systemic risk – and a cross-sectional dimension – micro-systemic risk. Macro-systemic risk arises from leveraged exposures to aggregate risks. Micro-systemic risk is the risk of disruption from individual failure, which can arise through a number of channels, such as the lack of substitutes for critical services provided, direct exposures between institutions, as well as fire-sales of assets and informational contagion. The rationale for intervention is that private agents are likely to underinsure against the externalities imposed on the system and the economy by a realization of systemic risk.

Prudential policy is not the only tool that can be used to mitigate systemic risk. Other tools include: (i) monetary policy, (ii) the oversight of payment and clearing systems and (iii) resolution tools, such as deposit insurance and special resolution tools. In each case, prudential policy needs to play a supporting role and be mindful of the limitations of other tools. It needs to complement monetary policy in reducing the probability and impact of aggregate financial imbalances. It needs to complement oversight by encouraging the use by banks of robust payment and clearing arrangements, reducing counterparty credit risk from the use of insufficiently robust systems. It finally needs to complement resolution tools, by reducing the probability of failure for those institutions whose failure poses particular challenges in resolution. To this end, prudential control needs to be increasing in the systemic risk posed by individual institutions.