Embargo: February,12 2013, 6:30 pm (CET)

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Financial Systemic Risk

The national and international dimension of macroprudential policy

Public lecture at the

International Center for Monetary and Banking Studies (ICMB)

Geneva

12 February 2013

– Check against delivery –

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Dear Prof. Wyplosz,

Ladies and Gentlemen!

Recently, *The Economist* reported that, more than a millennium ago, this very city was destroyed by a tsunami which came off of Lake Geneva. Today, we are coping with the fallout of a different storm: A financial one that took place in 2007 but has its roots in earlier years. Ever since, systemic risk and macroprudential policy are at the top of the agenda of policymakers, regulators and central bankers, and for good reason.

I appreciate very much having been invited today to share my thoughts on why macroprudential policy is of such vital importance. I will touch on its broader implications at both the national and the international level. Therefore, most of my comments are generally applicable, but allow me to voice some thoughts on the current debate in the European Union.

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The financial crisis has made it clear that systemic risk with its implications for financial stability was not given enough attention in the past. We have learnt the painful lesson that we have to put the financial system on a sounder footing, and we need to draw the right conclusions from the global financial crisis. The costs of inaction have been high, and doing nothing is simply not an option. Thus, our approach to regulation and supervision has to adapt to this insight and take a more systemic view. In this regard, let me suggest that one could draw a somewhat simplifying analogy to nature.

In nature, species or populations have to adapt to their environment in order to survive. In an evolutionary system, continuous development is vital merely in order to maintain the fitness of an organism relative to the system with which it is co-evolving.

Similarly, the financial sector as well as regulation and supervision may be considered as a system that is evolving over time. Its different players are continuously interacting with one another and must adapt to change in order to succeed. In the same way as financial institutions respond to legal constraints, the regulator has to take their reactions into account and set the right incentives to safeguard financial stability.

All players in a functioning financial system need to respond to new developments so that a balance can be maintained. From this angle, the financial sector can be seen to have become more globalised, more complex and more integrated. You will agree that therefore regulation constantly has to adapt to keep up with its changing environment.

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Adopting a systemic view is paramount. With this I mean it is of paramount importance to take due account of the external effects of individual actions and of their repercussions within the financial sector and, ultimately, of their implications for the real economy, sovereigns and taxpayers. In this sense, macroprudential policy provides a framework for thought and action, for deciding how much resilience we want and how much we are willing to pay for it.

2 National dimension: goals and interactions with other policy areas

But why do we need a distinct policy? Would it not be enough to take system-wide implications into account in other policy areas such as monetary and fiscal policy or microprudential supervision?

There are two main arguments why a specific macroprudential policy is called for and both of them I find important.

One is set out by Nobel laureate Jan Tinbergen in his contribution *"On the Theory of Economic Policy"*: achieving a number of goals requires an equal number of instruments. For example, setting the interest rate is effective when targeting a specific goal such as inflation. However, using one instrument to try to achieve multiple goals inevitably impairs the effectiveness of that instrument. So even though the interest rate impacts on financial stability, it is likely to clash with the objective of ensuring price stability. Moreover, it may be too blunt to achieve this policy goal, especially

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in a monetary union when risks originate from regions or sectors whose economies are not developing in sync.

The second argument: each policy area only should have goals that are not mutually conflicting. Would it be wise to make the Transport Ministry responsible for environmental protection? Or would it not be more sensible to have an Environment Ministry in charge of it? Assigning potentially conflicting goals to different policy areas ensures that each policy area is committed to its task.

Therefore, an independent macro-prudential policy safeguarding financial stability is needed and should be equipped with its own instruments. More precisely, there are two main objectives of macroprudential policy, which should be distinguished carefully.

First, it should provide a framework and rules that give the market participants appropriate incentives. This holds true in normal times but especially when crisis management measures have to be applied.

Second, macroprudential policy is about prevention. It puts in place instruments to keep systemic risk from building up over time. This can happen during times of exuberance when instruments have to be tightened. But it also can be necessary during downturns when previously accumulated capital or liquidity buffers can be released. Other instruments are designed to prevent spillover to other parts of the economic system.

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In order to achieve these two objectives successfully, macroprudential policy has to take into account interactions with other policy areas. This is because different policy areas might reinforce or counteract each other. Coming back to my previous words, let the following situation serve as an example: while environmental policy is trying to reduce traffic pollution, at the same time transport policy is promoting enhanced mobility and infrastructure improvements by having new roads built.

The same issue about reinforcing and counteracting effects applies to the interaction between monetary policy and macroprudential policy.

In the short run, a potential conflict between the two policy areas cannot be ruled out. This might be the case if real and financial developments diverge, for example when monetary policy should be tightened but the financial system is stressed. Or it could happen when an economy is undergoing periods of high productivity growth, which reduces inflation but at the same time may trigger irrational exuberance in financial markets. This, for example, was the case during the dotcom bubble at the turn of the century.

However, once a longer-term perspective is taken, tensions tend to disappear. Over such a time horizon, price stability and financial stability are complementary. Monetary policy needs a functioning transmission process and a healthy financial system in order to be successful, while price stability is a key precondition for financial stability.

Similarly, there are interactions between macroprudential policy and fiscal policy. They are interrelated because banks hold a large quantity of their own

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government's debt in many countries. Unsustainable public finances have a direct impact on the rating of sovereign bonds and thus on banks' balance sheets. As a consequence, waning market confidence, losses and strained funding conditions can be detrimental to the resilience of the financial system as a whole.

Fiscal policy can also impact on financial stability through tax incentives. Just think of the role that tax incentives play in the overheating of real estate markets, for example by promoting owner-occupied housing through overly generous tax deductions for mortgage lending rates. Or think of the widespread preferential treatment of debt over equity. Thus, macroprudential objectives may sometimes conflict in the short run with political objectives pursued by means of tax policy.

Even so, by setting the right incentives, taxation also can be a useful tool for safeguarding financial stability. Some activities, such as excessive short-term funding, represent a systemic risk and could be curbed by an appropriate levy. This would make them more expensive and thus less attractive for market participants.

Finally, macro- and microprudential policy can crucially impact on one another. Both aim to enhance resilience and ensure stability. However, one focuses on single entities, while the other looks at the system as a whole. And even if the tools employed often work in the same direction, they may not always be perfectly aligned.

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Microprudential regulation sometimes favours investment in certain “safe” asset classes. However, this may conflict with financial stability concerns as common exposure could involve systemic risk. Awareness of spillovers and feedback effects is a very important first step. It also fosters the understanding that both policies should complement each other. Achieving microprudential objectives depends on a stable financial system. Conversely, a stable financial system builds on sound individual institutions.

In my home country Germany, a new institutional setup for macroprudential policy takes these interactions between policy areas into account. A Financial Stability Committee has been established; it comprises representatives from the Bundesbank, the federal Financial Supervisory Authority and the German Finance Ministry. Together, they are in charge of designing consistent macroprudential policies. By involving different institutions, this setup ensures a comprehensive point of view.

Similarly, other countries will set up their own national macroprudential framework and take decisions regarding their financial system. Thus, measures will be adopted at the national level but will also have an impact across borders. Therefore, macroprudential policies will have to take spillovers into account. Equally, market participants must learn about the macroprudential policies of different jurisdictions. This thought leads me directly to my next topic: banking union and macroprudential policy.

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3 Banking union and macroprudential policy

In a financially integrated area such as the EU, spillover effects from one country to another are especially pronounced. Any national policy that affects financial stability might have an impact not only at home but across borders, too. This holds true not only for any measure taken but also for measures not taken.

Furthermore, the developments of the last years have dramatically shown the perils of the sovereign-banking nexus. The proposal for a banking union in the EU can be seen as a step towards better addressing spillover effects and disentangling sovereign and banking risks.

The banking union will start with a single banking supervisor. With a common set of rules on microprudential regulation, a European supervisor will be best placed to ensure a common supervisory practice. This is to avoid forbearance or a policy of "too little too late". Inaction can lead to severe problems in financial institutions and contagion in the financial system. Moreover, a European supervisor helps to preserve a level playing field, which is essential to the single market.

However, as envisaged by the banking union, a common resolution scheme should soon complement a single banking supervisor. First of all, it will ensure that owners and creditors bear the risk of their investment. A common resolution scheme would also avoid inconsistencies and frictions that could otherwise arise between a single supervisor and national resolution authorities. Ultimately, it could significantly improve the way in

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which we cope with failing internationally active banks. Their orderly recovery or resolution is a key element of financial stability and cross-border effects play a crucial part in it. A common resolution scheme will also help to reduce negative spillover from the banking sector to governments. Should public backstops be necessary to fund the resolution of banks governed by the single supervisory mechanism, a burden-sharing agreement will have to be in place.

A banking union surely contributes to financial stability. But it is not a panacea. Current financial risks in national banking systems developed under national supervision. Thus, the ultimate responsibility is national. Any other solution would be a fiscal transfer and should be treated as such, including obtaining the obligatory democratic legitimacy.

Setting up a banking union and a single European supervisor also touches on institutional questions. Furthermore, it requires us to work out how the new set-up will relate to macroprudential policy.

Regarding the institutional framework, it must be ensured that the conferring of any supervisory powers on the ECB does not call into question the independence of monetary policy and the central bank's mandate for price stability. But I will not, at this point, go into further detail about the design of the banking union. Instead, I would like to expand briefly on the relationship between a banking union and macroprudential policy.

In contrast to the common set of rules of microprudential regulation, the essence of macroprudential policy is to detect, assess and respond flexibly

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to a build-up of systemic risk wherever and whenever it occurs. Even with a banking union, cyclical patterns in the euro area will vary to some extent. Under a single monetary policy, regionally differentiated macroprudential policies are vitally needed to combat systemic risk.

But who should be responsible for implementing macroprudential policies?

On the one hand, there are arguments for national authorities. Given that the macroeconomic costs of a systemic crisis are borne largely nationally, it seems reasonable to assign national authorities the responsibility to cope with the changing nature of systemic risk. Furthermore, a granular understanding of the national economy and the financial system is needed. National policies will involve implementing specific measures, such as the countercyclical capital buffer, sectoral risk weights or capital or liquidity surcharges.

On the other hand, national authorities may sometimes be biased towards inaction. Or they do not fully take into account spillover effects, whose potential costs have to be shared in a banking union. This might be addressed by assigning the power to tighten national macroprudential policies to the European level. Indeed, in December 2012, European finance ministers agreed to confer this power to the single banking supervisor.

At present, the European Union already has an independent body responsible for macroprudential oversight: the European Systemic Risk Board. Within its framework, there are established rules for the interplay between European and national authorities. This includes accountability on a

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"comply or explain" basis. As opposed to the single supervisory mechanism, the ESRB comprises all 27 EU member states. It also is not confined to the banking sector but rather addresses the entire financial system.

The responsible parties now have to figure out how to fit the macroprudential aspects of the banking union and the ESRB together. While it is too early to know what the final setup will look like, the ESRB will certainly not become obsolete. It plays, and will continue to play, an important role in coordinating policies.

4 Concluding remarks

In conclusion, let me return to the analogy I used at the beginning of my speech. Macroprudential policy can be understood as a framework for responding to needs that have arisen because of the way the financial sector has developed. Thus, macroprudential policy seeks to restore the balance in the financial system populated by market participants, regulators and supervisors.

Unlike in evolution, the objective has been set. Nevertheless, to achieve the desired goals, interactions with other policy areas as well as cross-border spillovers still have to be taken into account. As a consequence, market participants themselves will have to adapt, to comply with new regulatory requirements and to develop their own responses to a changing environment.

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Some responses might turn out to be unnecessary for a healthy economy. But former Fed Chairman Paul Volcker was taking things to extremes when he said, "*The only useful banking innovation was the invention of the ATM*". Other innovations, however, are beneficial to the development of our financial system, and those should be the ones that survive.

The potential failure of the financial system can come with a huge price tag for society. For this very reason, a stable system is essential. Macroprudential policy will have a key part to play in this, and national macroprudential responsibilities are about to be assigned in many countries. Appropriate instruments now need to be developed and implemented; we will have to "walk the talk". This will be a major challenge for some time to come.

Thank you very much for your attention to the topic which is close to my heart.

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