Sabine Lautenschläger: Current developments in macroprudential oversight

Speech by Ms Sabine Lautenschläger, Deputy President of the Deutsche Bundesbank, at the 14th Handelsblatt Annual Conference "Update on Banking Regulation", Mainz, 6 November 2013.

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1. Introduction

Dear Mr Afhüppe,

dear Professor Schulte-Mattler,

ladies and gentlemen

The flyer advertising this event invited us to "keep our finger on the pulse of developments in banking regulation". In my opinion, the heartbeat of regulation cannot be overheard; it beats fast, almost a staccato – if you consider the wave of regulations over the past five years and the changes in the approach to supervision. Today, I would like to discuss one of the three major changes that face banks and supervisors – and will possibly get your pulse going in the future.

What changes am I referring to? The first major change are the completely revised rules for banks, known as "Basel III". The second change is the banking union. Both subjects have already been discussed at length and in great detail. I therefore propose to talk about major change number 3 today, "macroprudential oversight". It is my impression that banks and market participants have, to date, paid too little attention to the ways in which this new type of supervision could affect them. However, the potential impact of the instruments available for this task should not be underestimated; on the whole, they are directed at banks, they may affect a category of banks or a national banking industry, and may impact all of the business or just individual business areas. This raises elementary questions such as that of a level playing field.

2. Macroprudential oversight: definition and background

What is macroprudential oversight anyway? Before the financial crisis, financial supervision dealt mainly with individual market players or individual institutions. Put simply, the motto was: if all is well at the individual institutions, all will be well with the system. Attention centred on the micro level; the macro level was not monitored and evaluated systematically, at least not at the national level. Macroprudential oversight is intended to do just that: its aim is to identify and assess, in a timely manner, developments that could jeopardise the financial system. We – the Bundesbank – define financial stability as the ability of the financial system to fulfil its key economic functions at all times – in particular, to efficiently allocate financial resources and risks, and provide an efficient financial infrastructure. However, the objective of macroprudential oversight is not just to analyse and identify risks to financial stability: it should also warn those responsible and recommend measures that will contain any risks to the proper functioning of the financial market or – better still – nip them in the bud.

The financial crisis has clearly demonstrated why macroprudential oversight is important. It showed that tensions and imbalances in individual areas of the market or at individual market players may jeopardise the system as a whole. For instance, we saw that developments that appeared harmless in relation to just one institution caused considerable systemic risk when a larger number of institutions were affected. However, the crisis also demonstrated that we need suitable international agreements to identify vulnerabilities in the financial system early and combat them effectively. This is particularly important in a world in which the globalisation of the financial markets and technical progress in data processing mean that markets and market participants are increasingly interconnected.

A key lesson from the crisis is therefore: a macroprudential perspective must be added to microprudential oversight.

3. Objectives of macroprudential oversight

However, the difficulties start with the question of what concrete goal macroprudential oversight should have. As I said earlier, the main intention behind macroprudential oversight is to reduce dangers threatening the financial system as a whole. As I see it, macroprudential oversight can take two directions: macroprudential activities may focus on increasing the resilience of individual systemically important market players. Alternatively, the goal may be to reduce procyclicality.

The aim of raising market players' resilience is virtually self-explanatory. In the event of a crisis, players have more room for manoeuvre if they are more stable. They become distressed less quickly and must, for instance, resort to fire sales less quickly; nor do they need to curtail lending as much.

But what is procyclicality and why is it worth monitoring? Procyclicality in the financial system is the result of self-reinforcing feedback effects between the financial system and the real economy. Financial markets may amplify the real economic cycle and thus lead to economic overheating or an overall recession. Such developments are, moreover, frequently accompanied by destabilising effects for the financial system. Think, for instance, of a pervasive real estate crisis or a credit bubble. It is therefore absolutely vital not to lose sight of the financial system's often procyclical behaviour.

In a nutshell: the objective may be to prevent a bubble emerging or to prepare market players for the bubble bursting. Now, you might interject that this distinction between two objectives is somewhat artificial. After all, some measures address both goals. That may be true. Nonetheless, when deciding on a measure, it is important to consider not only where the danger is coming from and what concrete measure would be suitable to combat it. Macroprudential supervisors must also be interested in the size of the potential damage if they do not take the measure. Because that determines how much the measure can interfere with third parties' rights – and that doesn't only mean banks' rights.

However, not only the objectives of macroprudential supervision must be clear, but also what dangers or risks macroprudential supervisors should be monitoring. May these only be domestic dangers or should they also include risks that emerge outside of the supervisor's own territory but may have far-reaching consequences – such as the US subprime crisis? Must harmful incentive structures arising from legislation, say tax legislation, be monitored alongside the infrastructure critical for the smooth functioning of the markets? The wider the circle of dangers to be monitored is drawn, the more important is international coordination, amongst other things. The wider the circle of dangers to be monitored is drawn, the more important are measures that target not only banks. And we have a long way to go in both areas, in international coordination and on the macroprudential toolkit for non-banks.

4. Measures of macroprudential oversight

The question that springs to mind is: what do we do after identifying a danger? What sort of measures are at our disposal? Some measures target individual players, others affect cyclicality. I would like to give you a few examples.

An almost trivial, but still important way to prepare market players for a crisis are measures focusing on capital levels. If they are sufficiently large, capital buffers strengthen the financial sector's resilience to systemic events and reduce contagion risk. Sufficiently capitalised financial institutions have more leeway in a crisis before they have to reduce risk assets or curtail lending. As a result, they are less cyclical in their actions.

Banks are even less cyclical in their actions if the capital buffer is additionally anticyclical. Such buffers “breathe” with the economic cycle. They are established in “good” times, ie times in which there is a risk of a credit bubble emerging. They consequently have a dampening effect on lending and ensure that banks have reserves in “bad” times. Measures aimed only at individual business areas are also conceivable. For instance, capital backing for real estate loans could be raised in order to dampen lending.

If capital requirements breathe with the cycle, they act in two ways: they strengthen the individual market player and they dampen cyclical fluctuations.

The appropriate use of macroprudential measures is anything but easy, however. And this is where it really gets difficult. The measure must not only be suitable, it must also be the mildest possible. The choice of instrument must be suitable and the timing must be right – the measure must not be deployed too soon. The dosage must also be correct; and there must be transparent triggers, for both when to deploy them and when to phase them out. Some thought must therefore also be given to how long they should be in place. With anticyclical instruments, in particular, the phase-out period, ie when the dampening effect stops, can be just as important as the phase-in period, ie the dampening itself.

However, another area is also vital to macro policy: the macroprudential toolkit still needs some work – at both the national and the international level, as the only measures currently available are those laid down in the CRR and the CRD IV; and those deal exclusively with credit institutions. We lack instruments at the European level that target the behaviour of insurers or other market players.

I will leave it at that, and now turn to the key players in macroprudential oversight.

5. Responsibilities for macroprudential oversight

As critical developments on financial markets know no national borders, macroprudential oversight and, in particular, any measures resolved, have to be harmonised internationally. Comprehensive and close cooperation between various national and international forums is necessary for measures to have any kind of effect and for the playing field to be as level as possible. Early warning systems that lack a mechanism to exchange information across borders or are not harmonised are pointless. “State of play” reports from countries facing critical developments can provide important information about potential vulnerabilities in other countries.

However, in the macroprudential area too, it is not just a question of bilateral cooperation between the individual national institutions. Strategies and tools have to be developed to enable a structured exchange of information to take place and to harmonise courses of action. European and global forums are thus required.

Which forums exist already? The Financial Stability Forum (FSF) was founded back in 1999. In 2009, this forum was expanded to include all of the G20 countries and has been re-established as the Financial Stability Board (FSB). The FSB is one forum active in international macroprudential oversight. It deals with endogenous risks in the financial sector, ie vulnerabilities that either originate in the financial system itself or are amplified there. For instance, this could be shadow banking activities to generate liquidity in the financial system.

The European Systemic Risk Board (ESRB) began its macroprudential oversight duties in 2011. Its membership includes the European Central Bank together with the national central banks, the European Commission, representatives of ESRB committees as well as the three European financial supervisory authorities, namely the EBA, ESMA and EIOPA. The ESRB was primarily conceived as an advisory body. It can issue warnings and recommendations.

The “comply or explain principle” applies to ESRB recommendations. If institutions do not follow recommendations issued, they have to state their reasons why.

The ESRB has an additional mandate, namely to ensure that countries do not take macroprudential measures at the expense of other countries. National macroprudential forums therefore first have to check with the ESRB before proposing measures that have a cross-border effect.

The macroprudential forum in Germany is the Financial Stability Committee (Ausschuss für Finanzstabilität or AFS). The AFS was set up this year. It provides an institutional framework for the cooperation between BaFin, the Federal Ministry of Finance and the Bundesbank, which are the institutions that previously shared information informally about the macroeconomic situation in Germany and the rest of the world. Within the AFS, the Bundesbank is responsible for macroprudential oversight. The Bundesbank can propose that the AFS issue warnings and recommendations. If the AFS believes that certain developments pose considerable risks to financial stability at a national level, it can make a public statement to that effect – and, most importantly, it can do this when signs of the risk are emerging, meaning it does not have to wait until the risk has fully materialised. It can also recommend that macroprudential measures be implemented. Then, we – the Bundesbank – monitor and evaluate the implementation.

But why do we need our own national infrastructure when we already have the ESRB? Despite the financial sector having a strong international focus, the nation-state is still of key importance. Risks to financial stability are heavily affected by national factors such as the structure of the financial market, bank customers’ economic situation, financing requirements in the real economy or the national legal and fiscal system. It is thus essential that macroprudential oversight gives adequate consideration to national factors. It is for this reason that Germany, too, needs its own infrastructure. The major challenge here will be to strike the right balance between the need to address cross-border risks whilst at the same time ensuring that national factors are not short-changed.

The European Central Bank (ECB) is also to be involved in macroprudential oversight. The Single Supervisory Mechanism (SSM) is currently being set up. The ECB will be given both microprudential and macroprudential powers which it can exercise over institutions in the SSM member countries.

While national authorities will retain their powers to deploy macroprudential instruments at national level, they will have to inform the ECB of these measures in advance – and the ECB will have the power to make them stricter. Of course, there is no guarantee that the national supervisory authorities will share the SSM supervisory bodies’ conclusions and recommendations – or the other way around for that matter. I therefore believe that we will see intensive discussions and a need for coordination between the two levels.

6. Conclusion

This year we have officially begun our macroprudential oversight of the German financial system. We have thus learnt a key lesson from the financial crisis, even if much still remains to be done before the mandate is fully implemented. I hope my talk has helped to keep your finger on the pulse of developments.

There is no doubt that many a major challenge still awaits those involved in macroprudential oversight. I expect the implementation of macroprudential measures will require a high degree of coordination, especially if European or international forums do not fully share the conclusions and recommendations of national authorities.

Whatever challenges remain, I am certain that, through the institutional framework which we have established, for instance, by setting up the ASF and our growing expertise in macroprudential oversight and policy, we have laid a solid foundation for ensuring financial stability in the future.

However, we must not forget that macroprudential oversight is only one aspect of safeguarding financial stability.

Thank you for your attention.