

The Role of Macro-Prudential Supervision

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(A) Why needed?

The achievement of price stability does not guarantee financial stability. The attempt to achieve both targets with a single instrument, the official interest rate, would cause a variety of problems. So there is a need for a further instrument(s) to achieve the second target. This second (set of) instrument(s) should provide what is known generically as 'macro-prudential regulation'.

Discussions on such a second set of instruments have differed between Europe and the USA. Europeans have advocated counter-cyclical regulations adjusted by the relevant authorities. Americans have tended more towards market-based insurance mechanisms.

(B) What instruments?

1(a) European-style counter-cyclical mechanisms

Systemic regulation and supervision needs to be introduced, and will help by itself (ESRB).

- Time and state varying capital requirements, (including dynamic pre-provisioning)
- Time and state varying liquidity requirements
- Time and state varying housing requirements

(All a form of margining)

More fundamental suggestions: remove, or reduce, tax allowance on interest rates, restrict limited liability.

1(b) Problems of European counter-cyclical measures

- Measurement and application; What is systemic? That too is state and time varying.
- Level Playing Field and cross-border problems.
- Runs contrary to market forces; rules vs discretion for regulators, (comply or explain). Can they be reduced in downturns?
- Will it restrict size of controlled banking system too much? Border problems.
- Can regulators manage markets? 'Regulation is static; markets are dynamic'. Need for careful ladder of sanctions, a prior failure of BCBS.

2(a) American style insurance mechanisms

- Pre-funded levies on riskier portfolios (NYU, FDIC).
- Contingent capital (CoCos) (Squam Lake, Flannery).
- PCA by means of capital (FDICIA), CDS (Hart/Zingales).
- Other measures to prevent TBTF; limitations on size?

2(b) Problems of American Proposals

- Triggers
- Pricing
- Cost on banking system
- Does it prevent bubbles?
- Will it prove time consistent?

3 Conclusions

European and US proposals not mutually exclusive and anyhow overlap. What will be balance between them?

(C) Who should be in charge?

Crucial issues is LOLR. If LOLR left with CB, then a systemic regulator outside the Central Bank has no means to protect against illiquidity/insolvency. Logic and Occam's Razor would then suggest Twin Peaks approach. CB does macro-regulation; FSA does micro-regulation. (Separate Product Regulation). No sensible CB should ever want to do:-

- Micro-regulation (reputational risk/expertise);
- Product regulation;
- Insolvency resolution.
- But they protect turf, like everyone else!

If Systemic Agency gets control of LOLR, then CB cannot control its own balance sheet. CB becomes little more than an interest-rate setting bureau. What would happen to payment system? Would systemic agency become the real new CB?

How about Central Bank independence? An issue that has been much exaggerated, especially in USA. Whenever taxpayer funds are at risk, government must be involved. No reason why an institution (such as the CB) should not be able to manage two functions, of which one (macro monetary policy) is independent from government, while second (financial stability) is joint with government.

That said, CBs should not put taxpayer money at risk without government authority. Much easier to do in Europe where executive dominates legislature, than in USA, because of separation of powers, checks and balances. In USA how can you get Congressional authority in time to defuse crisis? A major political and constitutional issue for Americans. How can you resolve it?