Understanding the macro-prudential debate: overview of the underlying issues
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Abstract:
The article aims to outline the rationale behind the ongoing debate on the overhaul of the regulatory environment of banks, which was triggered by the global financial crisis of 2008-2009. The focus remains on propositions of developing of a so-called macro-prudential oversight framework.

The tool of analysis employed is literature review. Included papers represent both - contemporary contributions on the issue, as well as selected original conceptual papers.

The main findings include tracing the evolution of the approach towards macro-prudential financial oversight from a banking sector stability-oriented tool, to an essential part of the macroeconomic policy mix. The article also provides a glimpse of how theoretical considerations are starting to feed through to practical institutional solutions.

Keywords: macro-prudential, banking supervision, financial oversight, global financial crisis
Introduction

The aim of this article is to provide an overview of the contemporary macro-prudential oversight debate. As the issue attracts ever more attention, both from the academic and practical point of view, the spectrum of participants interested in the dispute expands. As many of the concepts and expressions used in the deliberations concerning the financial regulations remain problem-specific, they might not be fully understandable to the public. Therefore, an outline of the basics of the macro-prudential framework and a brief illustration of the practical implementation of the concept may help to better comprehend the on-going evolution of ideas in this field.

Overview of the content

The article outlines recent developments in the field of financial regulation. It explains the reasons for the increased prominence of the topic in the contemporary scientific debate, as well to provides basic conceptual framework for understanding the issues related to macro-prudential oversight of the financial sector.

Part 1 presents the factors that triggered interest in the area of financial regulation, with the financial crisis of 2008-2009 playing a central role. In part 2 a glossary of basic problem-specific expressions (used in the article) is provided to ensure proper understanding by the reader. Part 3 deals with the purposes which the macro-prudential supervision may or should serve. Arguments for the assigning of the mandate to central banks are suggested in part 4. Ideological and institutional solutions for establishing of oversight regimes are indicated in part 5. Finally, part 6 of the article, illustrates the issue of setting up new supervisory entities, using real life examples.

1) The catalyst for debate

Some events in economic history have such profound consequences, that they set new standards of conduct and reshuffle the hierarchy of economic doctrines for years to come. The global financial crisis – which started at the turn of 2007 and 2008 – may be perceived as such a momentous turning point. Although, as some scholars suggest, banking crises are everything but unusual1, yet taken into account the scope and the scale of the financial havoc brought about this time, and above all – considering the vigorous dispute among economists that followed – it is difficult to neglect the importance of such an experience.

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1 See: (Reinhart and Rogoff 2009)
One of reasons for the outbreak of the 2008-2009 crisis – often quoted in the literature – was inadequate (Wong 2009), or rather ineffective (Hubbard 2011:77), regulatory environment of the financial sector. Authors argue, that due to lax prudential rules, and the lack of intervention on behalf of supervisory authorities when it was needed, banks and non-banking firms from the finance sector managed to make excessive use of a long period of asset price inflation, which eventually turned against them and ended up in losses of epic proportions. Thus, the main development visible in the post-crisis literature is the postulate to establish an oversight framework aimed at boosting the stability of financial systems through the development of the so-called macro-prudential approach, alongside the traditional focus on the soundness of individual institutions, clients and investors known as the micro-prudential view (Basel Committee on Banking Supervision 2010:1). Furthermore experts in the field opt for a far reaching overhaul of regulatory regimes of the financial sector in order to coordinate the monetary and supervisory policies, incorporating them into a comprehensive tool-kit for counteracting boom-and-bust cycles (Sławiński and Chmielewski 2011:1).

Some scholars called for strengthening the macro-prudential focus of regulations well ahead of the 2008-2009 crisis. Although the financial instability was hoped to fade away over time, the issue was still perceived as one of paramount importance (Borio 2003:2). In fact postulates for greater risk exposure control of banks by supervisory authorities can be already found in the literature of the 1990s. At the time the idea was referred to as “off-site surveillance” methods, but has attracted only limited attention, and was prone to misinterpretation (Polizatto 1990:25). The origin of the expression “macro-prudential” itself is traced back to 1970s, and the minutes of the Cooke Committee's meetings (Galati and Moessner 2011:4). After the outbreak of the 2008-2009 financial crisis systemic safety concerns quickly gained prominence and together with them the macro-prudential concept, which provided a convenient platform for facilitating underlying issues. The idea became the main theoretical foundation of reforms within the financial oversight universe (Borio 2010:1).

The case for an overhaul of the approach towards financial regulation finds its justification in the poor track record of prudential rules during the boom-and-bust cycle of the last two decades. The paradigm of self-regulation of market participants is nowadays being described in the literature as a failed ideology, “guided more by theory than historical experience” (Moss 2011:99). The traumatic evidence of the latest crisis provides an ideal opportunity for far-reaching changes in the field of financial supervision, yet the task requires much attention to merit and commitment for
implementation. Theory needs to provide the background for future solutions, but many areas of dispute remain unresolved. Still, the time for change is now and the scientific debate needs to keep pace with the momentum of the underlying reality.

The article primarily focuses on the banking sector regulation (not the financial industry as such). This is due to the vital role of banks in modern, western-style economies as intermediaries in the resources allocation process, as well their role in the 2008-2009 crisis.

2) The basics

The issue of macro-prudential financial oversight was not a mainstream topic until very recently. Being addressed only by a handful of specialized individuals the concept was described with the use of expressions which may not be intuitively clear to every reader, or might become subject to multiple varying interpretations. Therefore it seems essential to agree on some core definitions, that enable the further discussion to be unbiased by misunderstandings.

In this article the following expressions will be defined as follows:

**Distress (situations)** – disruption in the functioning of financial institutions, markets, or their systems, eventually often leading to large-scale losses on behalf of entities involved, and/or their clients.

**Credit crunch** – usually used as a synonym of the 2008-2009 financial crisis; also a symptom of the crisis itself, manifested by increased problems in obtaining credit by potential borrowers, due to risk-aversion of lenders.

**Contagion** – spreading of financial distress across institutions, sectors, countries via a domino effect; Channels of propagation of contagion include (among others): perception of idiosyncratic factors as representative for a whole peer group of entities, deteriorating business conditions for clients of failed institutions due to increased scrutiny on behalf of the latter, disruption of day-to-day conduct of interconnected financial intermediaries due to distress situations at their business partners, spiralling effect of fire-price asset sales and shortage of credit due to the increased risk aversion of lenders (Hubbard 2011:79).

**Systemic (stability risk in the financial sector)** - posing a threat of system-wide or a market-wide distress, additionally exacerbated by externalities that financial institutions may inflict on each other via contagion (Hubbard 2011:79).
Macro-prudential regulation - focuses on acting against the outbreaks of financial distress and its feeding through to the real economy in the form of large-scale losses of output. The macro-prudential perspective deals with the economic environment (thus, also the financial system) in aggregate. Moreover, the risk of triggering negative repercussions for the economy by the financial sector is, at least in part, treated as endogenous – because rational decisions of economic agents with regard to their own business may (e.g. due to correlation of activities) cause irrationality in the system as a whole. Therefore, the potential threat of distress may come from within the sector (Borio 2003:3).

Micro-prudential regulation - takes primarily into account the soundness of each individual institution, in order to counteract defaults (thereby ensuring client/investor protection). According to this view, the nature of systemic risk is largely exogenous, because the whole framework is considered to be safe, as long as each supervised member of the system is not threatened with failure. As a consequence - assuming that all included economic agents are sound - a threat of distress may only come from an outside shock (Borio 2003:3).

3) The purpose of macro-prudential oversight

As indicated in the glossary section, macro-prudential policy can be understood as a framework of employing supervisory tools, for the purpose of boosting the stability of financial systems of countries/regions.

According to Borio, as far as the design of the new financial stability system is concerned: “if the problem is one of overextension in good times then at least part of the answer is to find ways of keeping that overextension in check. As always, prevention is better than cure. The challenge, therefore, is to design a policy response that addresses this constant feature of financial instability while at the same time tailoring it to the evolving profile of the system” (Borio 2007:11). The citation is a down to earth formulation of the general logic behind the macro-prudential concept, yet as a fairly new subject of high profile scientific discussion the framework raises a host of fundamental questions.

There is no ultimate consensus in the literature concerning what in the above mentioned context financial “stability” or “safety” actually means. Furthermore, the disruptive factors at play may eventually not necessarily need to be addressed by the macro-prudential policy. Opinions can be found, that the macro-prudential approach should not be mistaken with other actions, which may profoundly contribute to systemic safety within the financial sector, yet actually are not a part of the
mandate (Borio 2010:3-4). The two extreme views on the nature of systemic safety are, that the concept either reflects the endurance financial systems to external shocks, or that it represents the ability to facilitate crises dependent on internal factors (Galati and Moessner 2011:6).

According to Borio, a prerequisite for a regulatory framework to be treated as macro-prudential is to take comprehensive view of the sector, incorporating the correlations between individual players – instead of just adopting a “sum-of-the-parts” methodology used by micro-prudential supervisors. As a consequence, risk to systemic safety is regarded under this approach as endogenous – dependent on the collective behaviour of the members (Borio 2010:2). Indeed, a situation in which rational behaviour in micro scale triggers negative consequences in macro terms is recognized in economic literature and referred to as “fallacy of composition” (Koo 2009:17).

The call for a the macro-prudential view to incorporate the endogenous risk perceptions model seems of paramount importance, especially when confronted with alternative approaches. Some initiatives, which are thought to be aimed at addressing the issue of financial systems' stability, eventually – despite assumed best intentions - seem to boil down to the re-definition of old supervisory principles using new nomenclature. The main trap that decision makers may find themselves in while trying to forge an outline of a new financial oversight regime is focusing on the potential shocks caused by different market participants, rather than on the implications that such externalities may bring for the rest of the industry (Bailey 2011:3).

Another intriguing question is what exactly should regulators strive to achieve, while resorting to the use of the macro-prudential tool-kit? The two stances at the distinct sides of the spectrum of opinions assume that policy-makers should either aim to play a passive or an active role in managing systemic risk.

The former case accounts for making sure that financial institutions (banks in particular) enjoy sufficient capital cushion to withstand negative consequences of a distress situation once it happens. In other words, it is sufficient to promote strengthening of capital buffers of financial institutions, in order brace for a potential crisis.

The latter approach calls upon watchdogs to try to engage in actions, designed to “diffuse” a looming bubble, thereby preventing the crisis from happening in the first place, by tackling the causes of distress. Borio suggests the active policy as the ultimate goal of regulatory overhaul, but advises the adoption of the passive approach ahead of more sophisticated schemes. He believes that the reform is too complicated to be successfully conducted in just one go, thus the need to start with low-profile changes, that will eventually evolve into full-fledged solutions (Borio 2010:5-12).

Some of the comprehensive propositions go a step further. They argue that while designing the new
financial oversight framework, decision makers do not only face a trade-off between an active or a passive approach towards systemic safety of banks. A more fundamental choice, with potentially far reaching consequences, is the decision if macro-prudential policy should be limited only to financial sector stability goals, or rather would it be proper to introduce elements of the framework as components of the macroeconomic stabilization policy mix (alongside monetary policy). In other words, should the macro-prudential mandate aim only to secure the soundness of banks, or is it appropriate to use the underlying policy tools for triggering macroeconomic adjustment processes that help economies converge to the path of sustainable growth. Arguments suggest that the latter may well be a smarter way forward (Sławiński and Chmielewski 2011:15-17).

Regardless of the choice of goals for the new macro-prudential authorities, another resulting controversy is - to what extent should the employed policy tools be automatic or discretionary. Automatism has the obvious advantage of preventing inaction on behalf of regulators, caused by complacency due to the lack of proper perception of risk (biased by cyclical factors). On the other hand, discretionary measures let policy-makers take into account idiosyncratic aspects applicable to the specific distress situation. The intermediate idea is for the automatic solutions to become a means of early warning against a potential build-up of risk. As a next step, discretionary calibration of policy tools would be advisable to tailor the supervisory response to specific conditions (Borio 2010:5-12).

Another feature of the macro-prudential concept, which might be a cause of confusion in the course of the policy debate, is the dual nature of systemic risk recognition. Two angles of analysis may be employed in this case, focusing on different aspects of the build-up of crises. The approaches are referred to as the “cross-sectional” and “time” dimensions (Caruana 2010:1).

The cross-sectional one – accounts for the concentration of risk at a given point in time. In other words, this approach strives to find out what is the distribution of risk among different factors / institutions. This perception allows for the identification of potential sources of vulnerabilities in the system. For example, some banks may be more exposed to property market lending than others, thus they may be more vulnerable to a contraction in the real-estate prices.

The second dimension aims at assessing the build-up of cumulative risk levels over time. Referring to the earlier citation of Borio, this angle is due to grasp the magnitude of overextension taken into account the build-up of crisis-triggering factors over time. In a nutshell, the main task in this case is to comprehend the actual counter-cyclical nature of risk cumulation (high reversal risk should cause economic agents to be more cautious), as opposed to the usual pro-cyclical nature of risk.
perception (the greater the boom, the safer marker participants feel).

Bluntly put, the cross-sectional view aims to predict where distress situations may happen, and the time dimension shows how advanced the process of triggering the distress is. The macro-prudential oversight framework needs to take both of these issues into consideration.

As for the time dimension, it is understandable that the focal point of the macro-prudential oversight is based on the ability to measure and classify systemic risk. As Borio put it already in his 2002 paper, the main focus of macro-prudential studies should be on crises derived from common exposures of financial institutions to macroeconomic factors. Such a general trend can (or largely must) result in ever greater correlation between businesses, and to exaggeration of imbalances, which may eventually lead to overextension, and a crisis. He added, that in the underlying case, negative shocks account mostly for the asset side of balance sheets, as the predeceasing boom is usually driven by asset price bubble. Borio downplayed the importance of systemic contagion mechanisms, which in the course of the 2008-2009 experience proved overly optimistic (Borio 2003:10). Still the overall scenario closely matched the very process, that is nowadays thought to be at the root of the global financial meltdown.

With regard to the cross-sectional dimension the 2008-2009 crisis contributed to the practical understanding of the issue. Vast financial institutions (banks in particular) sometimes become so deeply interconnected with the rest of the sector (as well as with non-financial economic agents), that their bankruptcy may trigger repercussions of systemic scale. This dilemma is usually referred to as the “too big to fail” syndrome.

An inherit part of systemic risk perception is the identification of institutions that pose potential safety threats. Such a selection provides supervisors with two main advantages. First, it enables the ex-ante monitoring of crucial market players, in order to ensure their resilience against shocks. Secondly, it allows tailored design of ex-post intervention policies, should a financial disruption eventually occur (Tarashev, Borio and Tsatsaronis 2010:1). Detailed propositions, concerning the issue differ in terms of procedure. Under some approaches, the verdict of systemic significance could be challenged by the interested party, but eventually – if sustained – it implies the adoption of applicable prudential regulations (Moss 2011:105). Regardless of the differences of opinion concerning implementation, it seems that the authority to rule on the systemic importance of market players is – by the means of a general consensus – accepted as an inherit part of the macro-prudential mandate.
The above considerations have been presented from the standpoint of purposes, which the new oversight framework ought to serve. Naturally, one can assume other points of view, that eventually would lead to the development of further characteristics of the new supervision regime. On the operational level – for instance - Carney argues that the macro-prudential mandate can be divided into three functional parts: surveillance, policy tool design, and implementation (Carney 2011:14). However, such detailed analysis of technical aspects exceeds the scope of this article, which is meant to provide a conceptual overview of the framework.

4) Who should be responsible for the macro-prudential mandate

There is an on-going debate concerning the overhaul of the global financial oversight system. Some experts call for re-definition of the role of central banking after the 2008-2009 financial crisis, describing the latter phenomenon as a “once-in-a-lifetime” event (Cecchetti 2011:1). Under the pre-crisis conditions central banks were assigned a clear objective to ensure price stability within their jurisdictions. A macro-prudential mandate was implicitly associated with this function, although the task was only rarely explicitly included among prerogatives. The problem of responsibility for micro-prudential policy - especially in terms of the banking sector - was never clearly defined (Lamfalussy 2011:6-7). Although central banks still often have a say with regard to banking supervision, in case of many countries this task is also the domain of other entities (Barth, Gan and Nolle 2009:26-30). In the aftermath of the 2008-2009 crisis experience the issue that has been brought into the spotlight - as far as theoretical and practical deliberations are concerned – is how can the responsibility for the systemic safety of the financial sector be best fitted into the overall regulatory framework.

According to many authors, central banks – contrary to state treasury, or micro-prudential authorities – are well geared up for tackling financial crises via their traditional banking operations. These tap the troubled financial institutions directly, without the need to set up specially designed support vehicles (Lamfalussy 2011:7). However, such means are of greatest use under non-extreme conditions, when system-wide collapse can still be averted. They can be most efficiently used to counteract economic imbalances, rather than to fight their consequences. As the recent history shows, after the outbreak of a banking crisis of systemic proportions additional situation-specific policy tools often need to be put in place in order to deal with the fallout.

The issue of interaction and the overlapping character of monetary and macro-prudential policies is
not new. It has been identified as a under-explored field of research long before the outbreak of the 2008-2009 credit crunch (Borio 2003:359).

According to Ingves, systemic stability of the financial system is a prerequisite for the effectiveness of central banks' activity in areas such as monetary policy and supervision of payment systems. Moreover, as central banks are under most legislation regimes trusted with the function of the lender of last resort, it may appear logical that it is those institutions that should be best fitted to perform macro-prudential surveillance duties. Head of the Swedish Central Bank also raises an important issue, which indicates that monetary policy makers could well be the right choice when it comes to financial stability assignment. Regulators in the latter field will most often act under circumstances of imperfect information, aiming their decisions against potential (but not certain) cyclical bubbles or structural flaws. Therefore, they can expect to come under heavy critique once the time comes to “put on the breaks” on a rallying financial business. The independence that central banks enjoy - thanks to the decades-long development of the monetary policy framework - is a natural safety precaution against these types of pressures (Ingves 2011:23-24).

In the view of Papadems, safeguarding of financial systems' stability ought to be based on the following five prerogatives: “(i) the provision of liquidity to the financial system and the management of that liquidity; (ii) the provision of emergency liquidity assistance to illiquid, but ex ante solvent, financial institutions; (iii) the promotion of the stability of payment and settlement systems; (iv) the identification and assessment of systemic risks and the formulation of macroprudential policies aimed at preventing and mitigating those risks; and (v) advisory functions concerning the regulation and supervision of institutions and the development of the financial system” (Papademos 2011:26). He concludes that an entity most suitable to facilitate the described tasks is a central bank.

According to Carney, the macro-prudential surveillance task is a natural match for central banks, which due to their macroeconomic focus have vast expertise in the field. Through their operations, and functions (i.e. as the lender of last resort) they can also take advantage of first-hand market information, useful in diagnosing a potential systemic threat to the sector. To utilize their macro-prudential monitoring authority, central banks should also pro-actively contribute to the design of new policy tools, which would be proposed as a response to the recognized potential distress factors (Carney 2011:14-15).
5) Conceptual approaches towards financial regulation

Two aspects of regulatory regimes can be derived from the literature, with reference to their impact on the functioning of prudential authorities: the ideological foundation and the institutional set-up.

As for the underlying ideology, supervisory policy can be classified with reference to the extent to which financial watchdogs interfere in the business conduct of the supervised entities. The two extreme cases are: policy making via rules, or via principles (Pelaez and Pelaez 2009:3).

The former approach – adopted so far in the United States - is based on providing market participants with clearly defined legal requirements, which need to be complied with. Any deviation from the desired state ought to be investigated and amended. Thus, investors and clients are believed to be better protected under the framework, as violations of rules provide grounds for further legal action.

The latter view – enforced in the United Kingdom – puts the stress on providing general guidelines for the subordinated entities, rather than strict rules. On the back of such principles precedences are created, which in turn are regarded as commonly binding. Therefore, the system is more flexible, less repressive and generally encouraging for hosting financial institutions.

Despite being treated before the 2008-2009 financial distress as substitutes, both systems similarly fell victim to the credit crunch. This conclusion reinforces calls for vigorous work no new regulatory propositions. Latest contributions to the discussion opt for the regulation-by-rules approach as the correct way forward. The stance is motivated by the implicit pro-cyclical nature of supervision itself. According to the argumentation, the highest degree of scrutiny - with regard to financial oversight - is called upon in the bottom of the cycle, when the fallout of the crisis provides sufficient incentives for market participants to enforce high standards of self-discipline. On the contrary, in the boom phase, improving business conditions for the supervised entities enable regulators to follow a more lenient prudential approach (as excessive intervention seems both not proper and unnecessary). Therefore - so the proponents of rule-driven approach - regulation must be based on a hard core of rules that enable the watchdogs to take unpopular actions - contrary to a commonly shared market consensus - in order to act against the cycle instead of boosting it (Brunnemeier, Crocket, Goodhart, Persaud and Shin 2009:36).

On the grounds of theory, two solutions for the institutional set-up of prudential oversight can be found at distinct sides of the spectrum. Lamfalussy distinguishes between the integrated model and the cooperative model (Lamfalussy 2011:8).
The cooperative approach is based on the principle of assigning separate monetary policy and supervisory policy tasks to different entities – sometimes (as in the Unites States) with overlapping or even substitutable authority. As many specialists in the field point out, the system may promote not so much cooperation between financial watchdogs, as rather competition – leading in extreme cases to the so-called “regulatory arbitrage”, nowadays thought to be one of the reasons for lax business conduct standards in the pre-crises period (Cox 2011:158).

As the name suggests, the integrated model places multiple prudential policy tasks under the roof of a single institution. The main advantage of this approach is the (at least theoretical) ability to swiftly react to information circulating within such an entity, resulting in an efficient policy feedback mechanism to the diagnosed areas of distress. The downside of this set-up is that when a central bank is assigned the role of an integrated supervisor, a hypothetical situation may occur in which price stability tasks contradict the prudential policy tasks. Although such an event is largely regarded as unlikely (on the basis of the presented scenario analysis), it may be argued that “unlikely” does not mean “impossible”, and therefore such a case should also be accounted for while forging the structure of future supervisory system (Lamfalussu 2011:8-9).

The integrated model brings about another type of hazard for monetary policy makers. As well-defined as it was, the price stability assignment of central banks has been generally successfully fulfilled during the last couple of decades. The supervisory task – and with it the mandate to stay on guard of systemic stability of banks, or even of the financial system at large – is far less clearly described. The issue is subject to a heated debate by both practitioners and academics, yet no ultimate consensus is in sight (Subbarao 2011:30). Thus, as Crockett argues, the goals and measures for achieving systemic safety are not definitely put forward (Crockett 2011:19). As a consequence, it might be implied that the odds of central banks not being able to deliver on their new responsibilities remain relatively high. The intriguing question is: would a potential failure - with regard to prudential policy - put at risk central banks' reputation in terms of monetary policy, which eventually could negatively impact price stability (Carney 2011:17)? Naturally, it is difficult to answer this question without further thorough investigation, yet the point seems to be worth considering. Similarly, the interest in the structure of banking supervision has not yet been supported with thorough research, concerning the influence of the oversight model on the industry performance (Barth, Gan and Nolle 2009:32).
6) What practical impact did the macro-prudential debate have so far

With regard to the new financial surveillance system, opinions can be found that the “one-size-fits-all” approach is not the correct way forward (Carney 2011:14). Therefore it may be appropriate to consider each market, or country as a separate case. For the sake of synthesis, dominating approaches will be outlined.

As the calls for financial regulatory reform have gained tangible form over the post-crisis period, it is possible to observe how theoretical considerations feed through to actual real life solutions. A feature that is best observable – with reference to the urge for enforcing the macro-prudential oversight approach – is the setting up of new institutions, designed to tackle the problem. Examples of such initiatives are presented below as a practical illustration of the above considerations.

As a result of the 2008-2009 financial crisis experience, a multitude of propositions emerged for the re-defining of the U.S. regulatory system towards a higher degree of systemic-safety focus. Some concepts involved assigning the mandate solely to the Federal Reserve on the basis of its profound expertise and the complementary roles as the lender of last resort and the monetary policy maker. Other extreme solutions called for the establishing of a new entity to be put in charge of systemic safety supervision. The agency would take over the prerogatives of other regulators with regard to the underlining scope of oversight. Intermediate stances opted for the central bank to be accountable for the institutions regarded to be systemically important for the financial sector, whereas another watchdog could assume responsibility for all the other market participants (Hubbard 2011:94).

In the guidelines for the overhaul of the financial oversight system, the U.S. Department of Treasury put forward an initiative to set-up a “Financial Services Oversight Council to facilitate information sharing and coordination, identify emerging risks, advise the Federal Reserve on the identification of firms whose failure could pose a threat to financial stability due to their combination of size, leverage, and interconnectedness (hereafter referred to as a Tier 1 FHC), and provide a forum for resolving jurisdictional disputes between regulators.” (United States Department of Treasury 2009:10). The entity was designed to be chaired by the Secretary of Treasury, with the Chairman of the Board of Governors of the Federal Reserve System only taking on a role of a member. Thus, the bias towards government influence, rather than trusting the central bank with the macro-prudential mandate.

The proposition materialized in the form of a new legislation, commonly known as the Dodd-Frank Act. The Financial Stability Oversight Council was indeed established. Its main purpose is to
identify risks within the financial sector and to issue recommendations for the Federal Reserve concerning regulation of vast, complex, interconnected financial institutions in order to avoid the “too big to fail” dilemma in case of distress situations. Representatives of micro-prudential regulators (such as the Securities and Exchange Commission, and the Consumer Financial Protection Bureau) were included as members, to ensure the comprehensive character of oversight. Competences of the FSOC reach beyond advisory duties. The entity may empower the central bank to impose financial regulations on non-bank financial companies, if these are considered to be systematically important. Moreover, the Council has the right to grant the Federal Reserve permission to downsize overly expended institutions by requiring of them to spin-off excessive assets (this however only as the measure of last instance, if national stability is at stake) (Senate Committee on Banking, Housing, and Urban Affairs 2010:10).

On the European level, the main consequence of the credit crunch – with regard to the regulatory framework of the financial sector – was the founding of the European Systemic Risk Board. The entity shall be focused on preventing the propagation of externalities within the industry via contagion, thereby promoting systemic stability, which in turn is expected to support economic growth of the EU.

In the discussed case, the macro-prudential mandate has clearly been allocated to central banks, with the Governor of the European Central Bank being appointed for the Head position. Representatives of micro-prudential supervisors also have a seat on the Board.

A potential stumbling block for the ESRB's effectiveness is the fact, that it has no authority to impose legally binding directives on member states' financial watchdogs. Instead, the committee is to affect prudential policy makers via its high-profile endorsement of preferred actions and solutions.

The creation of the European Systemic Risk Board is an attempt to make sure that information, which is crucial for the systemic safety of financial institutions, is efficiently and effectively shared among member states', pan-European, and international supervisors. Still, the final success will largely depend on the ability of ESRB to identify potential sources of externalities, on the incentives for the Board to act, and on the willingness of local watchdogs to comply with macro-prudential recommendations (Koberska 2011:41-47).

An interesting initiative, aiming to establish an effective platform for cooperation between the central bank and the micro-supervisory authorities emerged in the UK. The idea is to found a Prudential Regulation Authority (as a subsidiary of Bank of England), which would be responsible
for the promotion of stability of the national financial system. The function involves duties which take advantage of the macro-prudential policy tool-kit, but are primarily based on the micro-prudential expertise of the FSA.

The ultimate goal of the initiative is to make sure that failures of supervised entities may be facilitated in an orderly manner, thus not triggering systemic repercussions. PRA does not intend to eradicate bankruptcies within the financial sector, as such an approach would only reinforce the moral hazard related to implicit government guarantees for entities regarded as “too big to fail”.

The proposition does not seem comprehensive. The framework concentrates on the attribution of externalities caused by the failure of each participant of the system, but does not explicitly take into account a possibility of a multiple failure caused by a common exposition to the same distress factor. As such PRA seems to be an intriguing solution with regard to the institutional set-up, but is in essence a reshuffled version of a micro-prudential supervisor (Bank of England, FSA 2011:4).
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