

Macroprudential Policy and Risk Management in Banking Sector

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Introduction

- A key missing ingredient during the financial crisis.
 - Difficulty to assess the magnitude of the exposures.
 - Increasing complexity and opacity.
- Need for a policy that explicitly focus on system-wide risks.

Macroprudential policy

- Uses prudential instruments to prevent and limit systemic financial risk and its consequences for the real economy.
 - Interacts with other types of public policies (Monetary and Fiscal).
 - A complement to microprudential policy.

Magnitude of risk

- Special focus on system-wide risks.
 - Risks arising within the financial system.
 - Risks amplified by the financial system.
 - Tail-risk approach (Extreme Value Theory literature).

Identify and quantify systemic risk

- Financial indicators with a critical threshold.
 - Economic and financial cycles,
 - Feedback effect from the financial sector to the real economy sector,
 - Financial institution contribution to systemic risk,
 - Leverage and liquidity ratios,
 - Probability of distress,
 - Extreme downside risk (Value-at-Risk, Expected Shortfall and Return level),
 - OTC derivatives exposure etc.

Institutional framework

- The institutional architecture is a central element of macroprudential policy.
- Two alternatives:
 - An authority with a clear mandate.
 - A mechanism of coordination between existing agencies.
 - Various recent examples (EU, US, UK).

Conflicting policies

- Complication to define a clear perimeter of regulation to reduce the regulatory arbitrage.
 - The primary objective of monetary policy.
 - The primary objective of the fiscal policy.
 - The primary objective of the prudential policy.

Conclusion

- ❑ Strengthen the resilience of the financial system and reduce the systemic risk.
- ❑ Clear hierarchy of policy objectives.
- ❑ Cooperation helps reducing international regulatory arbitrage.
- ❑ Trade-off for policymakers between the benefits of greater stability versus potential economic growth.
- ❑ *Further readings: IMF, ECB, FSR.*