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# Translating 'Macro-Prudential Supervision' Principles Into Law

A focus on the 'forest' instead of just the 'trees.'

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**S**PARKED BY THE RECENT financial crisis, the push to incorporate a "macro-prudential" or "systemic" component into the U.S. financial regulatory framework is being spurred on by both populist resentment over the use of taxpayer money to bail out institutions seen as "too big to fail" and cutting edge studies by financial economists within academia, think tanks and central banks.

Over the past few years, a growing chorus of scholars, regulators and lawmakers has argued that the basic design of the U.S. financial regulatory framework leads supervisory agencies to focus almost exclusively on the individual U.S. financial institutions that they supervise (the "trees") at the expense of the well-being of the financial system as a whole (the "forest"). Indeed it is now almost conventional wisdom that our predominantly "micro-prudential" (or, to follow the analogy, "tree") approach to regulation is a weakness in the U.S. regulatory framework. This weakness has been most recently and sharply exposed during the financial crisis which, in its most acute stage, brought our financial system to the brink of collapse.

The Obama administration, key U.S. Congressional leaders, and important financial industry groups all support the establishment of a "systemic risk" regulatory body to identify and monitor emerging system-wide risks as

well as the implementation of other measures intended to introduce a "macro-prudential" orientation (or a "macro approach") to U.S. financial supervision. Indeed, the identification and mitigation of systemic risks may be viewed as one of the broad themes running throughout proposed legislation to reform the U.S. financial regulatory system.

There appears to be a strong chance that many of the proposed reforms in this area will become law. Significantly, once enacted into law, such reforms have the potential to bring about an important change in the financial supervisory approach of the United States.

### What Is the Macro Approach?

While the financial crisis led the Obama administration and U.S. Congress to place systemic risk management high on the nation's financial regulatory reform agenda, the macro approach has been a topic of academic and policy study for a number of years. Indeed the notion of "macro-prudential" supervision, often more casually referred to as either "systemic risk" supervision or, even more loosely, "too big to fail" supervision, has received some attention in international bank supervisory circles for over 30 years.<sup>1</sup> The flood of reports on the topic, however, is largely a post-crisis phenomenon.<sup>2</sup>

While there is no universal consensus on the meaning of "macro-prudential" (in contrast to "micro-prudential") supervision, papers on the topic generally define the macro approach in terms of:<sup>3</sup>

(i) an overriding objective to maintain financial stability of the financial system as a whole, which is thought to be appropriate given the significant decline in economic wealth and activity that a system-wide failure could bring about; and

(ii) a particular focus on those institutions,



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activities and behaviors that are seen to most threaten financial stability; for example, these include large institutions (so-called "systemically important"), the infrastructure of the financial system, and linkages between financial institutions and markets.

In contrast, the focus of a traditional "micro-prudential" approach (or "micro approach") is on the financial stability of each individual regulated institution in order to achieve the overriding goal of protection of the customers (e.g., depositors and individual investors) of the institutions. For example, a traditional micro-focused bank regulatory framework is, in the first instance, intended to minimize the potential for depositors to suffer financial losses due to the mismanagement of a bank or a bank run.

Despite different objectives and orientations, the macro and micro approaches have certain common aspects. For example, well designed micro measures

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intended to ensure that individual institutions are “safe and sound” should reduce the risk of a potentially destabilizing bank (or other financial institution) failure that could have systemic implications. Indeed, as dramatically demonstrated by the fall of Lehman Brothers in September 2008, the failure of a single “systemically-important” institution has the potential to unleash a shockwave through the whole financial system due to linkages between financial institutions.

In addition, the two approaches generally share the same “tools.” For example, implementation of a macro approach often entails the recalibration of traditional micro-prudential requirements (e.g., liquidity requirements, minimum capital standards, loan provisioning requirements etc.) in order to achieve macro objectives.

The increasing call to incorporate a greater macro-component into the traditional micro-oriented financial institution supervisory framework, both in the United States and in many other countries, stems from several key observations, each a “lesson learned” or reinforced during the recent crisis. These observations include the following:

*Observation 1: There is a tendency for institutions to over-expose themselves during financial booms and become overly risk-averse during financial downturns.<sup>4</sup> Micro-oriented efforts to make institutions “safer” (e.g., capital charges that make it more expensive for institutions to lend during a time of market turbulence) may actually discourage the flow of credit and encourage “herding” into assets deemed to be safe, leading to overvaluation of the “safe” assets and amplification of the business cycle and associated systemic risks.*

*Observation 2: For the past quarter century, economic crises (e.g., United States 2007–2009 and East Asia in the '90s) have generally originated from common exposures to risks (e.g., a fall in housing prices or a currency depreciation) rather than from the failure of a systemically important bank bringing down others.* As evidenced by the recent financial crisis, a micro focus on ensuring the safety of individual financial institutions cannot ensure the stability of the financial system as a whole. Moreover, tighter prudential supervision of regulated entities may encourage the migration of higher-risk activities to unregulated sectors of the economy.

*Observation 3: The failure of a single systemically important institution inherently poses more risks to the system than the failure of smaller institutions.* Instead of forcing systemically important institutions to take into account (or “internalize”) the potential costs that their failure could impose on the remainder of the financial system, micro-oriented rules may have had a tendency to favor systematically important institutions

(e.g., through lower capital charges) given their more sophisticated risk management processes.

### The Historical Micro Approach

U.S. financial regulatory policy has generally remained focused on the “safety and soundness” of individual regulated financial entities (bank, insurance company, broker-dealer), a traditional micro approach to supervision. In general, to the extent rules or safeguards were designed to mitigate systemic risks (e.g., measures such as deposit insurance and emergency lending by the Federal Reserve), they addressed the potential of a financial crisis originating from either (i) the failure of one large bank, or (ii) a terrorist attack, natural disaster or similar large-scale disruptive event.

Perhaps the closest approximation to a U.S. systemic risk regulator under the current U.S. financial regulatory framework is the U.S. Federal Reserve Board through its role as the “umbrella regulator” of financial groups with

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U.S. banking operations. In this role, the Federal Reserve is responsible for monitoring risks created by many of the largest financial groups in the United States (in technical Federal Reserve parlance, “large complex banking organizations”).

Nonetheless, the Federal Reserve’s supervisory focus has remained on protecting the commercial bank within a holding company structure.<sup>5</sup> Moreover, systemically important institutions without U.S. bank subsidiaries (such as pension funds and former investment banks Lehman Brothers and Bear Stearns) fall entirely outside the scope of Federal Reserve comprehensive supervision.

### Five ‘Pillars’ of a Proposed Approach

On June 17, 2009, the Department of Treasury released a broad financial reform plan (commonly referred to as the Obama administration’s “white paper”) to serve as a template for future regulatory reform legislation. The white paper acknowledged that the current micro-oriented regulatory framework was not equipped to handle the financial crisis and laid the groundwork for

Congressional financial reform proposals including the bill passed by the House of Representatives, the Wall Street Reform and Consumer Protection Act of 2009 (H.R. 4173), on Dec. 11, 2009.

While the U.S. financial reform package will continue to evolve through the legislative process, it is clear that an important objective of any final law will be to move the United States towards a more coherent systemic risk framework. At this point, a proposed U.S. approach to systemic risk regulation would likely include many if not all of the following interconnected and self-reinforcing “pillars.”

*Pillar 1. A Systemic Risk Regulator.* A new U.S. federal systemic risk regulator (or council) would be established to identify and monitor systemic risks. The regulator would have authority to make recommendations to U.S. financial supervisory agencies (i.e., the micro-prudential authorities including the Securities and Exchange Commission, the Commodity Futures Trading Commission and the U.S. federal banking agencies) to implement new standards with a macro-prudential objective.

*Pillar 2. Additional Oversight of Institutions Deemed “Too Big to Fail.”* Systemically important financial institutions would become subject to a new supervisory regime marked by closer regulatory scrutiny and heightened prudential standards (including higher capital and leverage requirements, stress testing requirements, liquidity limits, concentration requirements etc.). The principal objectives would be to (i) offset some of the financial and regulatory “benefits” of size and ensure comprehensive oversight of every “too big to fail” financial institution (whether or not affiliated with a U.S. bank), and (ii) provide an extra capital “cushion” against failure of systemically important institutions.

Designated U.S. authorities would also have the power to break up a systemically important institution if the size and scope of its activities are deemed to pose a threat to financial stability.

*Pillar 3. Transparency in Financial Markets.* Additional reporting and disclosure requirements would be imposed on financial institutions and transactions in order to improve financial transparency and reduce uncertainty or misperceptions of risk that could amplify systemic risks (and lead to “herding” behavior, or a rapid contraction in lending, by financial institutions). These would include:

- (i) repository reporting relating to “over-the-counter” (OTC) derivatives transactions, and
- (ii) new reporting requirements for the private fund industry.

Information-sharing between the systemic-risk regulator and other U.S. regulatory authorities would also be put in place to

improve the prospect that macro-regulatory objectives of the systemic risk regulator will be achieved.

*Pillar 4. Reduction in the Cost and Systemic Risks of the Failure of a Financial Institution.* Statutory proposals that form part of this “pillar” include: (i) central clearing requirements for OTC derivatives currently cleared bilaterally, and (ii) a new resolution regime for systemically important non-bank institutions. The principal objectives would be to reduce (i) “moral hazard” associated with the “too big to fail” problem (i.e., lack of market discipline based on the expectation that it would be less costly for the government to bail out a systemically important institution than to allow it to fail), and (ii) the risk that the failure of an institution would have a “domino effect” leading to the failure of other institutions.

*Pillar 5. Counter-Cyclical Capital Requirements.* U.S. federal bank regulatory agencies would be statutorily required to introduce counter-cyclical elements into the regulatory capital adequacy framework. A buffer of bank capital would be built up during an economic boom so that the buffer would be available to absorb higher losses in stressful environments.

### Integrating the Macro Elements

Challenging issues relating to the integration of macro-elements into an established micro-supervisory framework will need to be resolved as part of the enactment and implementation of any U.S. financial reform legislation.

International supervisory groups in which the United States participates, including the Bank for International Settlements, have taken on an important role in terms of evaluating how best to implement macro-oriented principles into practical arrangements.<sup>6</sup> The United States may adopt many of the “best practices” developed by these groups, with modifications as deemed appropriate.

The following three “big picture” issues concerning the integration of macro-elements into the U.S. supervisory framework deserve careful consideration by U.S. policy makers:

1. What is the right balance between a “rules-based” and a “principles-based” macro-prudential framework?

2. What is the right balance between an “incremental” approach and a “bifurcated” approach to systemic risk regulation?

3. What is the right balance in terms of power and authority of the systemic risk regulator in relation to the micro-prudential regulatory authorities?

With regard to the first question, decision-makers will strive to find a workable balance between a more predictable (but less flexible) “rules-based” approach and a more flexible (but less predictable) “principles-based” approach. Left entirely to their own discretion, U.S. financial regulatory authorities might be reluctant to apply counter-cycle and other similar macro-

prudential measures that effectively take the “punch bowl” away during an economic boom.<sup>7</sup>

A set of macro rules could be designed to ensure that such measures would “automatically” kick in as soon as designated indicators of growth (or decline, as the case may be) are met. On the other hand, a system that relies too heavily on a rules-based approach may not afford regulators with the flexibility required to evaluate and properly respond to potentially critical differences in the underlying drivers of a particular economic “bubble” or downturn.

On the second question, an “incremental” approach, where the intensity of supervision is gradually ramped up as the systemic importance of the institution increases, may offer enhanced sensitivity to systemic risks, while a “bifurcated” approach, where only a relatively small number of designated systemically important institutions are subject to supervision and rules with a macro-prudential objective, may be simpler and less costly to implement.

The benefits of an “incremental” approach include (i) fewer economic distortions than the “dual system” bifurcated approach, which arguably grants “too big to fail” status to any institutions designated as systemically important, and (ii) appropriate recognition that even smaller institutions linked into the financial system could potentially pose systemic risks. However, it may not be necessary to adopt a true across-the-board “incremental” approach in order to mitigate the most significant systemic risks, and attempts to individually assess the specific risks posed by smaller institutions could strain regulatory resources and increase costs.

On the third question, one of the key issues is whether, and/or under what circumstances, micro-prudential regulatory authorities should be able to reject recommendations or directives of the systemic risk regulator. If allowed to “go their own way” and reject recommendations or directives of a systemic risk regulator, micro-prudential regulatory authorities could potentially undermine the overall effectiveness of an important macro-oriented policy. On the other hand, micro-prudential regulators may have special insight into how their institutions would likely respond to new measures, and thus, at least in certain circumstances arguably should have the right to reject recommendations/directives of the systemic risk regulator.

### Conclusion

Modification of the existing micro-oriented supervisory framework to include a greater macro-perspective holds the promise of reducing the risk of another system-wide financial crisis in the United States. Putting theory into practice, however, will be a daunting challenge given the dynamics of the financial system and the fact that there is no proven set

of guidelines to follow in most areas.

In view of the complexity of this task, there will almost certainly be a significant learning and testing period following the enactment of any new legislation. Initially, a major test for the success of the reforms will be how well the systemic risk regulator and other U.S. financial regulatory agencies are able to foster, and incorporate into policy and practice, advances relating to systemic risk-management.

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1. See, e.g., Maes, Ivo “On the origins of the BIS macro-prudential approach to financial stability: Alexandre Lamfalussy and financial fragility,” NBB working Paper 176, October 2009.

2. See, e.g., The Warwick Commission, “The Warwick Commission on International Financial Reform: In Praise of Uneven Playing Fields” (November 2009) (the “Warwick Commission Report”); Bank of England, “The Role of Macroprudential Policy: A Discussion Paper” (November 2009) (the “Bank of England Discussion Paper”).

3. Similarly, as discussed in the second report cited in footnote 6 below, there is no uniform definition of “systemic risk.”

4. See The Bank of England Discussion Paper.

5. See, e.g., speech by Federal Reserve Governor Daniel K. Tarullo, “Financial Regulation in the Wake of the Crisis,” June 8, 2009.

6. See e.g., Financial Stability Board report “Progress Since the Pittsburgh Summit in Implementing the G-20 Recommendations for Strengthening Financial Stability” (November 2009); Bank for International Settlements, Financial Stability Board, and International Monetary Fund report, “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” (October 2009).

7. See The Warwick Commission Report.

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