COURSE: COMESA WORKSHOP ON BASEL III

TOPIC : MACROPRUDENTIAL APPROACH TO SUPERVISION UNDER BASEL III

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VENUE: KENYA SCHOOL OF MONETARY STUDIES

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AGENDA

- Microprudential Vs Macroprudential
- Causes of Systemic Risk
- Common exposure
- Macroprudential Policy
- Macroprudential Policy Tools
- Regulatory Authority’s Program

A). MICROPRUDENTIAL Vs MACROPRUDENTIAL

Microprudential Regulation

- Microprudential regulation concerns itself with the stability of individual institutions. Microprudential regulation examines the responses of an individual bank to exogenous risks.
- It also ignores the systemic importance of individual institutions such as size, degree of leverage and interconnectedness with the rest of the system and the impact of the failure of such an institution could have to the rest of the financial system.

A). MICROPRUDENTIAL Vs MACROPRUDENTIAL

Microprudential Regulation

- Microprudential regulation ensure that each individual bank is managing its risks well and ensuring its stability.
- Having safe banks does not necessary guarantee the safety of the financial system as a whole.
- In trying to make themselves safer, banks, and other highly leveraged financial intermediaries, can behave in a way that collectively undermines the system.
- A bank selling-off a non –performing account to another bank may be considered a prudent response for an individual bank but that non-performing account still exist in the system.

A). MICROPRUDENTIAL Vs MACROPRUDENTIAL

Macroprudential Regulation

- The macroprudential approach to an increase in risk is to consider systemic behavior in the management of that risk: who should hold it, and do they have the incentive to do so?
- Macro-prudential regulation concerns itself with the stability of the financial system as a whole.

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Macroprudential Regulation

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- Major Objective
  - To minimize systemic risks

B). SOURCES OF SYSTEMIC RISKS

1) Common exposure

- common exposures can arise *directly* or *indirectly*. Intermediaries may be directly exposed through financial contracts to one large, but frail, institution. They also may be exposed through any counterparties who are themselves directly exposed. Or, they may simply be exposed to the same underlying risks.

2) Boom and Busts Cycle

- Procyclicality

C). COMMON EXPOSURE

- When many institutions, even small ones, have a common exposure to a specific risk, it can make the system vulnerable to even a small shock.
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D). MACROPRUDENTIAL POLICY

- Relying on someone outside the financial system to bear the costs of risky behavior encourages risk taking that can lead to a systemic crisis.
- Macroprudential regulation aims to make institutions bear – or *internalize* – the costs of their behavior, including the externalities (spillover costs) that fall on others.

E). MACROPRUDENTIAL POLICY TOOLS

- Supervisor can employ various regulatory tools such as capital surcharge depending on an institution's contribution to systemic risk.
- That contribution depends on an intermediary's interconnectedness and the riskiness of its balance sheet, and is often correlated with its size.
- Supervisor can also employ detailed inspection programe including frequent on-site visits to institutions that poses high systemic risks to the sector (i.e SIFIs)

E). MACROPRUDENTIAL POLICY TOOLS

- Stress-testing at macro level to assess financial sector vulnerability to different risks. (i.e sectorial lending)

F). REGULATORY AUTHORITY'S PROGRAM

1) Aggregate micro data,
2) Examine the relations between macro financial and macro real variables,
3) Forecast the future values of the relevant macroeconomic variables, after taking into account the interactions among them,
4) Estimate and evaluate the systemic risk,
5) Define policy decisions, at the macro level, to reduce systemic risk to the socially acceptable level,
6) Design regulations that translate macro policy decisions into signals (instructions/recommendations etc.) at the micro level.

Q & A

THANK YOU