The Micro and Macro Approaches: A Happy Marriage?

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Supervisors, regulators and policymakers all over the world have experienced difficult times during the financial crisis, fighting a war without an adequate arsenal. Indeed, one of the main lessons learned is that the focus on microprudential supervision alone is not enough to ensure financial stability. This needs to be supplemented by a macroprudential approach. To cite Crocket's (2000) words, financial stability can be most productively achieved if a better "marriage between the microprudential and the macroprudential dimensions" is achieved.

Can the micro and macro approaches have a happy marriage? My view is that they can, but there are several considerations to be made.

First, there is the need to have a **sound framework** in place, laying down a strategy that considers, among other things, the possible interactions between the micro and macro spheres in terms of objectives, tools to be used and side effects on the other area(s).

Secondly, endless debates on whether a certain policy is **micro or macro** should be avoided. Furthermore, I agree with the IMF (2013) that, although conceptually it is useful to split the two approaches, this separation is not easy to draw in practice. The same happens in a marriage. What matters is that both members contribute to the overall objectives of the household to the extent they can.

Thirdly, with regard to the **objectives**, although they differ in theory, in practice they will coincide quite often. It is widely acknowledged that the microprudential approach should focus on risks of individual institutions (with the protection of consumers being the ultimate objective), whereas the macroprudential approach should focus on system-wide distress to avoid output costs (Borio, 2003). In many instances, however, micro- and macroprudential policies will use similar or even the same instruments and will supplement each other. Furthermore, in the case of insurance, because of the way it exerts systemic risk compared to banking, this potential conflict is probably different in practice. However, further research is needed to better understand the sources of systemic risk in insurance as well as in the transmission channels.

Fourth, in situations in which the coexistence between the micro and the macro approach is not sufficiently smooth, there is a clear need for **coordination and cooperation**. In case of potential conflict between macroprudential and microprudential policies, a certain hierarchy between the policies should be considered. For example, it might be that during a severe crisis, financial stability considerations may temporarily have to take precedence to avoid the materialization of systemic risk and an impact on the real economy.

Fifth, in addition to ensuring coordination and cooperation to solve potential tensions, it is also important to ensure **consistency and complementarity** between the micro and macro spheres. Several microprudential instruments can be readily adapted to serve macroprudential objectives. Therefore, it is important to consider the combined effects of both policies to avoid overreactions or unintended counterbalances. The regulatory framework plays a key role in this regard. For example, one way to ensure consistency and complementarity between the micro and macro spheres in the EU will be to discuss all relevant micro and macro issues in the context of the Solvency II review in 2021 (EIOPA, 2016).

The coexistence of the micro and macro approaches, like any marriage, is not easy. It is almost certain that tension will arise at some point, but a clear framework, well defined objectives, adequate coordination and cooperation, as well as a proper regulatory framework should help overcome these difficulties.

References

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