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The Micro and Macro Approaches: A Happy Marriage?

Supervisors, regulators and policymakers all over the world have experienced difficult times during the financial crisis. With the benefit of hindsight, it seems clear that they were fighting the great financial war without having an adequate arsenal. Indeed, one of the main lessons learned during these challenging times is that the focus on micro-prudential supervision alone is not enough to ensure financial stability.

This needs to be supplemented with a macro-prudential approach. To cite Crocket’s (2000) words, financial stability can be most productively achieved if a better “marriage between the micro-prudential and the macro-prudential dimensions” is achieved. This principle is
It is widely acknowledged that the microprudential approach should focus on risks of individual institutions (being the protection of consumer 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 complement 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. This issue, however, points to an area where further research is needed, with the aim of better understanding the sources of systemic risk in insurance as well as the transmission channels.

In any case – as a fourth factor – in those 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. As explained by Osinński et al. (2013), tensions between micro and macroprudential policies are more likely to take place in the downturn of the business cycle. 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 the 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 and work as macroprudential instruments. At the same time, it is important to consider the combined effects of both policies to avoid over-reactions or unintended counterbalances. The regulatory framework plays a key role in this regard. For example, in the case of the EU, one way to ensure consistency and complementarity between the micro and macro spheres is 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: