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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 ▸

actually valid for all sectors across the financial system, despite the fact that the intensity and the way in which each sector may jeopardize the stability of the financial system differs substantially.

This article seeks to take the issue one step forward and consider the question of whether the micro and macro approaches can even have a happy marriage or not. My view is that it can indeed be happy, 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 the objectives of the different policies, the tools to be used and the side effects of using a particular tool 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 (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 macro-prudential 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. 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 Osiński 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. ◆

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