

# Toolbox for emerging risks



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### Identifying and addressing financial stability risks beyond the banking sector

The post-crisis financial reforms are providing granular data that enable policymakers to better identify emerging risks. This includes data on derivatives markets, securities financing transactions, and balance sheet items of banks and insurers. For example, the data on derivatives transactions reported under the European Market Infrastructure Regulation (EMIR) consist of around one hundred million observations per day.

Authorities are developing the infrastructure to analyse these data, but poor data quality is hampering progress. Investment in technology; collaboration between national authorities, the European Securities and Markets Authority (ESMA), the European Central Bank (ECB) and the European Systemic Risk Board (ESRB); and standardisation mean that EMIR data can now be prepared in seconds. However, more needs to be done to improve data quality. For instance, as reported in the financial press, data for February 2019 show that only 40% of swaps trades reported under EMIR are properly matched. Market participants only see their own transactions; if data quality was better authorities could publish more aggregate statistics on market structure and activity. Therefore, poor data quality not only impedes risk monitoring by authorities, but also reduces market transparency to the detriment of the financial industry.

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*"There is a lack of tools to address risks, particularly beyond the banking sector."*

- FRANCESCO MAZZAFERRO

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The ability to connect datasets will further enhance cross-financial sector analysis. This kind of analysis has already been carried out, with one example being the ESRB's 2016 report on macroprudential policy issues arising from low interest rates and structural changes in the EU financial system. As the ability to connect market data with balance sheet items increases, cross-financial sector analysis will become more detailed. Eventually authorities will be able to trace how shocks travel through the financial system with much greater precision than is currently possible. This will reveal fault lines in the financial system that would otherwise have remained hidden. >>>

>>> Risk monitoring and identification is improving, but there is a lack of tools to address risks, particularly beyond the banking sector. The non-bank financial sector has grown a lot in recent years and, as the capital markets union progresses, the role of non-bank finance is expected to increase further. The evolution of the macroprudential toolkit has not kept up with these developments. Indeed, macroprudential tools in the EU are, for the most part, aimed at the banking sector, which leaves a gap if risks to financial stability migrate to markets or non-bank financial institutions and/or new risks emerge beyond the banking sector.

The ESRB plays an active role in developing a broader set of tools and issued a recommendation in 2018 – before the recent events affecting some investment funds – to help address risks to financial stability that could arise from excessive leverage and/or liquidity mismatches in investment funds. Last year the ESRB, alongside the EIOPA, set out the types of tools that would help mitigate financial stability risks related to the insurance sector.

The ESRB is also contributing to the development of the policy framework. The experience with macroprudential policies is still at an early stage; for example, while the concept of a monetary policy stance is well established, there is no universally accepted equivalent for financial stability. To help address this gap, the ESRB published a report in April that sets out one approach to a framework for a common macroprudential stance. This framework compares systemic risk with the level of resilience in the system to arrive at a measure of the residual level of systemic risk. If this level is higher than the level accepted by the policymaker, the macroprudential stance is loose; if it is lower, the stance is tight; and if it is the same, the stance is neutral.

In summary, authorities' ability to monitor, identify and prevent or mitigate risks to financial stability has been significantly enhanced by the post-crisis reforms. However, as evidenced by the recent discussion on crypto-currencies such as Libra, the financial system is continuously evolving. Microprudential and macroprudential frameworks need to keep pace. ●



## Dino Falaschetti

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### A transaction-cost approach for managing systemic risks

#### Three C's of systemic risk

A recent book, *Fragile by Design*, highlights the remarkable frequency with which the U.S. has experienced “major banking crises” – once per generation since the Federal Reserve's founding. Given this track record, the authors suggest that we “should not expect politicians or regulators to do much to prevent the next banking crisis”.

Addressing this history, Harvard Professor Hal Scott offers a taxonomy of how problems at one bank can create difficulty for others<sup>2</sup>. He refers to these transmission channels as the “three C's” – that is, “connectedness”, “correlation” and “contagion”.

Each “C” characterizes a type of financial “externality”. But given the frequency of and variation in crises, are we confident that closing only three channels will guard against crisis? If not, perhaps we should address the common root of any such “externality” – that is, transaction costs.

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**>>> Transaction costs and financial resiliency**

The economics laureate, Ronald Coase, was remarkable. He created a new peer-reviewed journal after his 100th birthday. And in a famous 1950s seminar, he won over a formidable group of Chicago economists, convincing them that the root “Problem of Social Costs” (externalities, like systemic risk) lies with the real resources that are necessary to transact in goods or services – that is, time and effort to (a) identify prospects for mutually beneficial exchange, (b) evaluate the quality and quantity of goods and services that might be traded, and (c) enforce terms of any such trade. At each step, someone has to produce valuable information and productive governance services.

Absent transaction costs, none of the three C’s could exist. Consider the first C – “connectedness.” And notice that, when connections between Bank’s A and B are transparent (the extent to which A’s health depends on whether B can pay back a loan, for example), people can readily price how problems at B can become problems for A.

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*“Reducing transaction costs and increasing accountability is fundamental to managing systemic risk.”*

- DINO FALASCETTI

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A related story can be told about the second C – that is, “correlation.” If A and B own similar assets (e.g., home loans), then realizing risks from those assets could create a systemic problem. But this channel also exists only in the presence of costly information and lack of accountability.

Likewise, the third and perhaps most important C (contagion) cannot take root without transaction costs. If I am confident about the integrity of bank B’s balance sheet, and comfortable with its price, why would I run from B on bad news about A? Given these conditions, a run on A cannot tip me to anything I didn’t already know, or sow seeds of doubt about what I thought I knew. Instead, investors run when bank A’s trouble tells bank B’s investors that transaction costs may have left them blind to important risks.

**A better way – address the root of any systemic risk**

If transaction costs lie at the root of systemic risk<sup>3</sup>, then proposed reforms like Scott’s call for “a more complete public guarantee of short-term liabilities” do just the opposite. Managing systemic risk from the top down relies on what the Nobel laureate F. A. Hayek referred to as the pretense of knowledge. It has failed time and again.

Dodd-Frank’s preamble, instead, charges regulators and overseers to focus on a more robust governance framework – one that ends bailouts by increasing “accountability and transparency in the financial system.” Economizing on transaction costs and strengthening market discipline provides fundamental means to this end. ●

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1. Calomiris, Charles W. and Stephen H. Haber (2014). *Fragile by Design: The Political Origins of Banking Crises & Scarce Credit*. Princeton University Press.
  2. Hal S. Scott (2016). *Connectedness and Contagion*. MIT Press.
  3. Information markets may be able to help here. See, e.g., Matthew Beville, Dino Falaschetti, and Michael Orlando, “An Information Market Proposal for Regulating Systemic Risk,” *University of Pennsylvania Journal of Business Law*, Spring 2010.