Untested macroprudential tools struggle for credibility

Regulators are increasingly adopting countercyclical regulations to control real estate bubbles, but the jury is out on their effectiveness.

By Olesya Dmitracova

The Bank of England’s recent move to constrain mortgage lending is putting to the test the kind of tools policymakers hope could reduce the frequency and intensity of financial crises. Britain’s cautious experimentation with macroprudential policy – which targets trouble spots in the overall financial system rather than individual players – will add to as yet limited evidence of the policy’s effectiveness.

Worried about the runaway growth in house prices that is saddling home buyers with heavier debt, the Bank of England’s Financial Policy Committee (FPC) said in June that from October, subject to consultation, no more than 15% of new mortgages can equal or exceed 4.5 times a debtor’s income. And banks will also have to make sure new borrowers can still pay the mortgage if the benchmark interest rate rises by three percentage points.

Disclosures scrutinised as banks await ECB test results

Proposals for an international deal to facilitate the resolution of systemic cross-border banking groups, driven by the US and UK regulators, are facing a rising tide of objections just as the crucial G20 summit in Australia approaches in November. In addition to concerns about the viability of the plans among global systemically important banks (G-SIBs) and financial market participants, the authorities themselves are in a growing number of jurisdictions are also becoming more sceptical.

At issue are the two interlinked questions of who is responsible for resolving a large cross-border bank, and the bailing in of creditors as a means to fund the resolution process. In its November 2011 paper Key Attributes of Effective Resolution Regimes for Financial Institutions, the Financial Stability Board (FSB) outlined a choice between single and multiple point of entry resolution (SPE and MPE). Under SPE, the home resolution authority runs the process worldwide. Under MPE, each host supervisor may step in and resolve the subsidiary in its jurisdiction.

Paul Tucker, former deputy governor of the Bank of England, suggested in a speech in Switzerland in July 2014 that MPE would only be suitable “for those groups whose business model allows different business lines to be ring-fenced from each other financially and operationally”. This is not an approach favoured by many global banking groups.

If every jurisdiction is requiring enough resources to carry out resolution, to page 6

Regulator discord over resolution proposals

Divisions emerge between regulators over crucial international legal framework as G20 deadline nears.

By Philip Alexander
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be used to build a buffer as a cushion against a systemic event, as well as to directly target the systemic risk itself, such as the risk of a bubble forming.” says Cheng Hoon Lim, division chief in the Monetary and Capital Markets Department of the International Monetary Fund (IMF).

Whether macroprudential policy will always achieve those two broad objectives is uncertain as it is a relatively new type of regulation, especially in advanced economies. Nonetheless, a small body of research on countries that have applied the policy suggests it is a toolkit worth trying.

Mortgages in focus

The macroprudential arsenal is large, but recent debate has centred on maximum debt-to-income and loan-to-value (LTV) ratios, and capital and provisioning requirements. Caps on the ratio of debt to income – or loan to income as it is sometimes referred to – aim to reduce the risk of defaults by ensuring the borrower is earning enough to repay the loan in full. The debt-service-to-income (DSTI) ratio is a more common variation of this gauge.

A 2013 study of 57 economies by the Bank for International Settlements found that lowering the maximum DSTI ratio was the only effective way to slow the growth in housing credit. However, the measure did not significantly affect house prices and neither did the other seven macroprudential techniques examined: limits on credit growth and on banks’ exposure to residential property; LTV caps; adjustments to the risk weights of housing loans; changes in provisioning requirements; and rules on how much banks should hold in liquid assets such as government bonds, and how much in reserves, which are either cash or reserve deposits at the central bank. The only policy tool that dampened house price inflation was a change in property-related taxes, although it had little impact on mortgage lending, the research showed.

The findings are important because housing bubbles pose one of the greatest threats to rich economies. Scarred by the 2008 financial crisis that originated in the US mortgage market, these countries are now leading the efforts to make some macroprudential standards binding globally via Basel III.

“We wouldn’t be talking about macroprudential regulation or about systemic risk if it weren’t for real estate... In developed economies that’s the story,” says Charles Calomiris, a finance professor at Columbia Business School who is also a researcher at the US Treasury’s Office of Finance Research.

Broader toolkit

When it comes to keeping broader credit and leverage stable, regulators may have a bigger trove of useful tools at their disposal, according to preliminary findings by the IMF. A 2011 working paper, co-authored by Ms Lim, drew on data from 49 countries and concluded that DSTI limits, countercyclical capital requirements, LTV caps, dynamic provisioning, reserve requirements, and ceilings on credit and credit growth all reduced the pro-cyclicality of credit and leverage – that is, their tendency to rise and shrink in line with the business cycle.

Pro-cyclicality can be damaging because excessive credit growth often fuels asset bubbles, while a sharp fall in lending during an economic contraction amplifies the downturn. High leverage, for its part, makes bubbles particularly destructive when they pop.

Countercyclical capital rules, whereby capital demands on banks change over time, encourage lenders to beef up their capital cushion when the economy is booming. When its fortunes reverse, banks can draw on the rainy-day fund and continue lending. The rules also enable regulators to put a lid on brisk credit growth.

A minimum risk-weighted capital ratio sets out the appropriate level of capital as a percentage of a bank’s total assets. These are measured according to their estimated riskiness so that safer exposures receive a lower weight than those with a higher probability of default and bigger likely losses.

Mr Calomiris says a temporary rise in capital requirements would be the best way to stop a lending boom and suggests capping LTV ratios permanently to stave off future housing bubbles. In contrast, some countries that have restricted how much can be borrowed relative to the value of a property have adjusted the ratios over the credit cycle.

“It would be much better just to set them permanently at a sensible level and then you don’t have to vary them. It’s like you could tell your friends to go get drunk and then give them a lot of coffee, or you could just tell them not to get drunk,” says Mr Calomiris.

Buffer zone

While capital requirements are meant to cover unexpected losses, provisions absorb projected losses from individual loans. Dynamic or time-varying provisioning forces banks to forecast losses in good times as if the economy were contracting. This way they should have enough of a buffer to see them through an economic slump.

Dynamic provisioning is probably the best-known macroprudential tool thanks to its use in Spain in the years before the financial crash. The authors of the 2011 IMF study judged that the instrument helped cover some of Spanish banks’ rising credit losses during the crisis, but the severity of the losses meant they still required a bail-out.

Others are less convinced. Patricia McCoy, a law professor at Boston College Law School and a former US mortgage market regulator, wrote in a recent conference paper: “Spain’s experience with dynamic provisioning was equivocal at best.”

The ability of dynamic provisioning to meet the other, preventative, objective of macroprudential policy is also in doubt. Since the measure was introduced in Spain, private credit had grown faster there than in the UK, the US, Switzerland and Germany, the FPC noted in a 2011 discussion paper.

Leverage experiment

Controversy is also on the cards for the latest high-profile addition to the macroprudential arsenal – a time-varying leverage ratio. A minimum leverage ratio,
already used in some countries, dictates the necessary level of capital in relation to a bank’s total assets that are treated equally, without adjusting for their riskiness. This has the advantage of simplicity and avoids the problem of potential understatement of risks.

The variable version of the ratio is being considered in a number of countries, and the UK is a vocal proponent. In July, the FPC called on the government to give the committee powers over a time-varying leverage ratio before the previously agreed deadline of 2018 “to help mitigate any potential financial stability risks over the next few years”.

The ability of time-varying macroprudential controls to prick emerging bubbles before they burst depends to a large extent on getting the timing right. Whether that is possible remains a moot point.

“Destructive bubbles in financial and asset markets are rarely deflated until it is too late. No one at the time knows what the equilibrium price is for any given asset, as it is only with hindsight that enough information is available,” the Independent Economists Group set up by TheCityUK, a lobby group for the UK’s financial sector, wrote in a report in June.

Tempering the credit cycle on the way down presents another potential challenge. Regulators hope they can boost the flow of lending when the economy is weak by easing macroprudential requirements. In practice, it is unclear whether the impact of macroprudential policy is always symmetrical.

Research published in the Journal of International Money and Finance last year analysed data from 48 countries and showed that while a number of macroprudential tools were effective in boom times, few helped stop declines during economic downturns.

Paul Sharma, managing director at consultancy Alvarez & Marsal and formerly deputy chief executive of the UK Prudential Regulation Authority, explains why relaxing regulation may have little effect in bad times.

“My view is that time-varying standards are more likely to be helpful reducing the size of the bubble as it inflates than reducing the size of the bust as it occurs,” writes Paul Sharma.

Patricia McCoy
“Spain’s experience with dynamic provisioning was equivocal at best”

because they will just be ignored by the market on the downside due to the rush for safety,” he says.

The old-fashioned way
The success of macroprudential policy, static or dynamic, is also tied to its interaction with monetary policy. Although the two have different targets, the level of interest rates – aimed primarily at controlling inflation – will usually have a side-effect on the macroprudential objective of financial stability.

A prolonged period of low interest rates, such as that experienced by the US, Japan and Europe, can spur excessive risk-taking and lax lending practices. One way to counter that is to tighten certain macroprudential settings in the overheating financial sectors, as the Bank of England has done. However, some argue that when monetary policy is ultra-loose, no macroprudential levers will be able to offset its destabilising effects.

“It would be much better just to set [loan-to-value ratios] permanently at a sensible level and then you don’t have to vary them. It’s like you could tell your friends to go get drunk and then give them a lot of coffee, or you could just tell them not to get drunk”
– Charles Calomiris

He says the central bank should raise interest rates, warning that if the macroprudential steps the policymakers have taken do not work as they expect, “then the danger is that they have to raise interest rates more sharply in the future”.

There may be other circumstances when macroprudential policy proves powerless against financial over-exuberance and monetary policy should step in. For example, regulation may be tightened too late, too much or not enough, which is particularly likely given the lack of experience with macroprudential tools.

Still, using interest rates to fight financial imbalances has trade-offs. For the Bank of England and the US Federal Reserve, macroprudential policy remains the first line of defence against bubbles.

In the words of former Federal Reserve governor Jeremy Stein, monetary policy “gets in all the cracks” by changing borrowing costs for everyone and making it harder to evade regulatory curbs. That is an important advantage – but also a major flaw.

“Monetary policy is a very blunt instrument... because it will affect all asset classes, and often when you have an asset bubble it only is a bubble in one asset class,” says Ms McCoy. “The really well-tailored tool is prudential oversight, and the monitoring and regulation of underwriting practices.”

More worryingly, past experience indicates that raising interest rates to deflate housing bubbles can deal a disproportionate blow to growth in gross domestic product. An IMF working paper published in July this year adds to a growing set of arguments that macroprudential policy should be the primary weapon against a build-up of financial risks.

Using a model, the researchers found that the new toolkit is better suited to curbing excessive leverage than interest rate hikes. Contractionary monetary policy can even have the unintended consequence of increasing leverage, they wrote, as it creates a temporary recession that encourages borrowers to take on more debt to keep consumption steady. In addition, the higher interest rate increases the borrowers’ debt burden.

September 2014  globalriskregulator.com
September
Sep 1 Financial Stability Board to publish its report on processes to enable jurisdictions to defer to each other’s rules in cross-border over-the-counter derivatives
Sep 9-10 International Centre for Insurance Regulation joint conference on global insurance supervision, Goethe University, Frankfurt
www.iicr.de
Sep 12 Closing date for EBA consultation on draft regulatory technical standards on assessment methodologies for the advanced measurement approaches for operational risk.
www.eba.europa.eu
Sep 13 Closing date for EBA consultation on draft guidelines (on materiality, proprietary and confidentiality, and disclosure frequency) related to information disclosure under part eight of the Capital Requirements Regulation
www.eba.europa.eu
Sep 19 Closing date for responses to Basel Committee on Banking Supervision consultation on supervisory guidelines for identifying and dealing with weak banks
Sep 23 Annual Europe Conference, International Swaps and Derivatives Association, London
www.futuresindustry.org and www.foa.co.uk
Sep 24 Deadline for responses to consultation on revisions to core principles for effective deposit insurance systems, International Association of Deposit Insurers
www.iadi.org
TBA Financial Stability Board plenary meeting
www.financialstabilityboard.org
TBA Basel Committee to conclude quantitative impact study on the fundamental review of the trading book

October
Oct 1 UK Financial Conduct Authority restrictions on distributing bank contingent convertible bonds to retail investors come into force for one year
Oct 9-12 International Monetary Fund/World Bank Annual meetings, Washington DC
www.imf.org/external/am/2014
Oct 10-11 Annual meeting of the Institute of International Finance, Washington DC
Oct 19-21 American Bankers Association annual convention, Dallas, Texas
www.aba.com
Oct 20 The New Shape of Banking, London
www.chathamhouse.org/Banking
Oct 20-25 International Association of Insurance Supervisors annual conference, Amsterdam. This year’s theme is enhancing policyholder protection and financial stability through governance and risk management
www.iaisweb.org
Oct 28-29 Seminar on liquidity risk management in Islamic and conventional banks, organised by Islamic Financial Services Board and Financial Stability Institute, Doha, Qatar
TBA Publication of results from European Central Bank comprehensive assessment of 128 eurozone banks, including asset quality review and stress test

November
Nov 4 Single Supervisory Mechanism assumes full responsibility for the eurozone banking sector
Nov 4-6 Futures Industry Association 30th Annual Futures and Options Expo, Chicago
www.futuresindustry.org
Nov 15-16 G20 leaders summit, Brisbane. International Association of Insurance Supervisors to publish final Basic Capital Requirement before this meeting.
www.g20.org
Nov 15 Expiry date for US Commodity Futures Trading Commission (CFTC) no-action relief on mandatory trading of packaged trades that include at least one swap already designated made-available-to-trade on a swap execution facility
www.cftc.gov
TBA Financial Stability Board to announce updated list of global systemically important insurers, potentially including reinsurance companies for the first time

December
Dec 3-5 FIA Asia Derivatives Conference
www.futuresindustry.org
Dec 15 Deadline for EU to confer substituted compliance on foreign central counterparties under European Market Infrastructure Regulation