BANK FOR INTERNATIONAL SETTLEMENTS

Macroprudential policies: Seven issues and seven questions

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Seven issues and seven questions

1. Finance is special, but can come with problems

   Why exactly are macroprudential policies (MaPs) needed?

2. As MaPs are being used, empirical evidence is accumulating

   What are outstanding empirical issues?

3. MaP and monetary policy (MoP) may need to be coordinated

   How to coordinate MaPs and MoP in practice?

4. MaPs are used in a globalised world, with capital flow management (CFM) tools

   How to balance, coordinate MaP and CFM tools?

5. Need to consider risks within non-bank markets

   What is the best MaP approach for risks within non-bank markets?

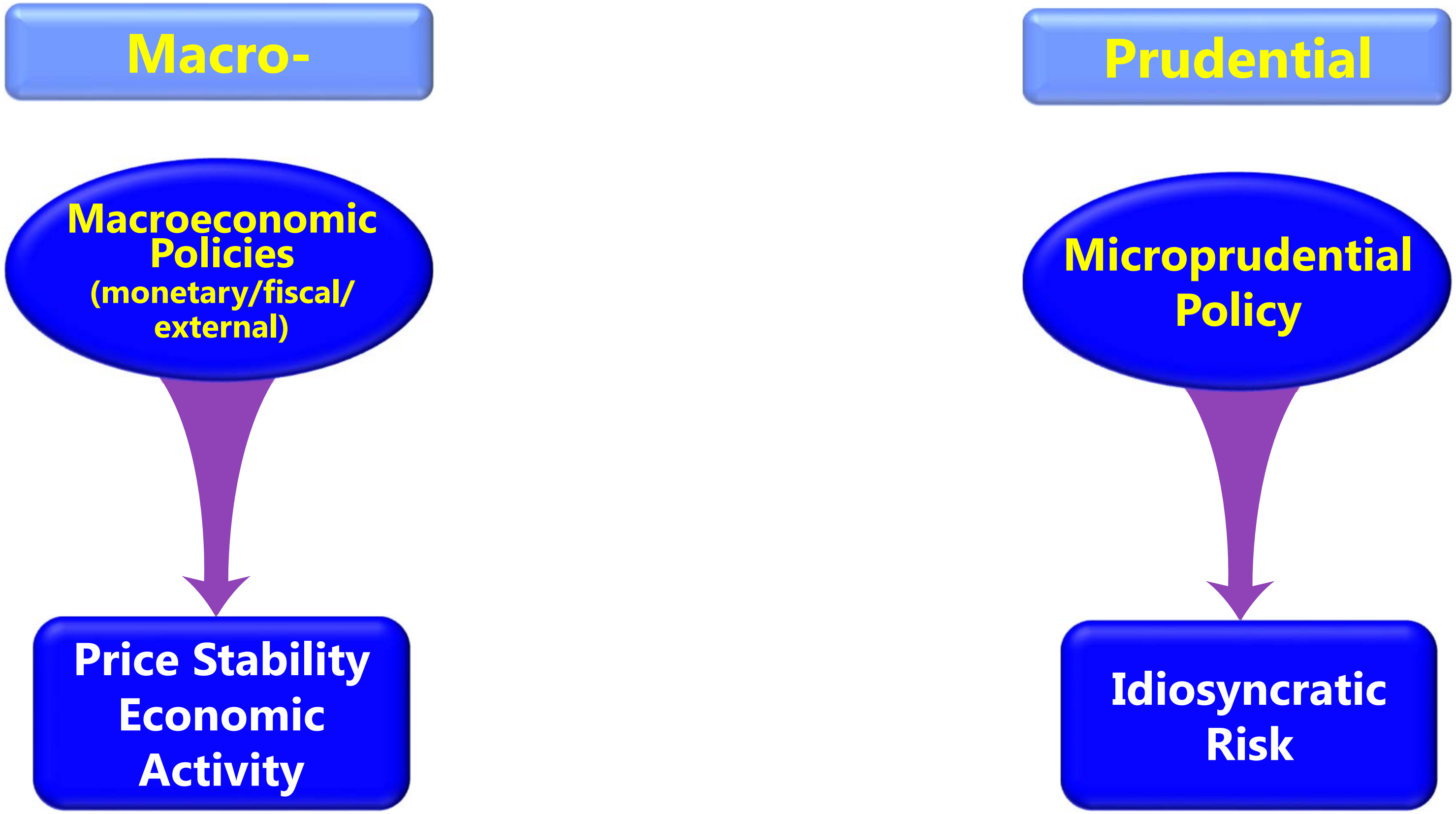
6. Data on systemic risks is still incomplete, and market discipline on system is limited

   How can better data and market discipline complement MaPs?

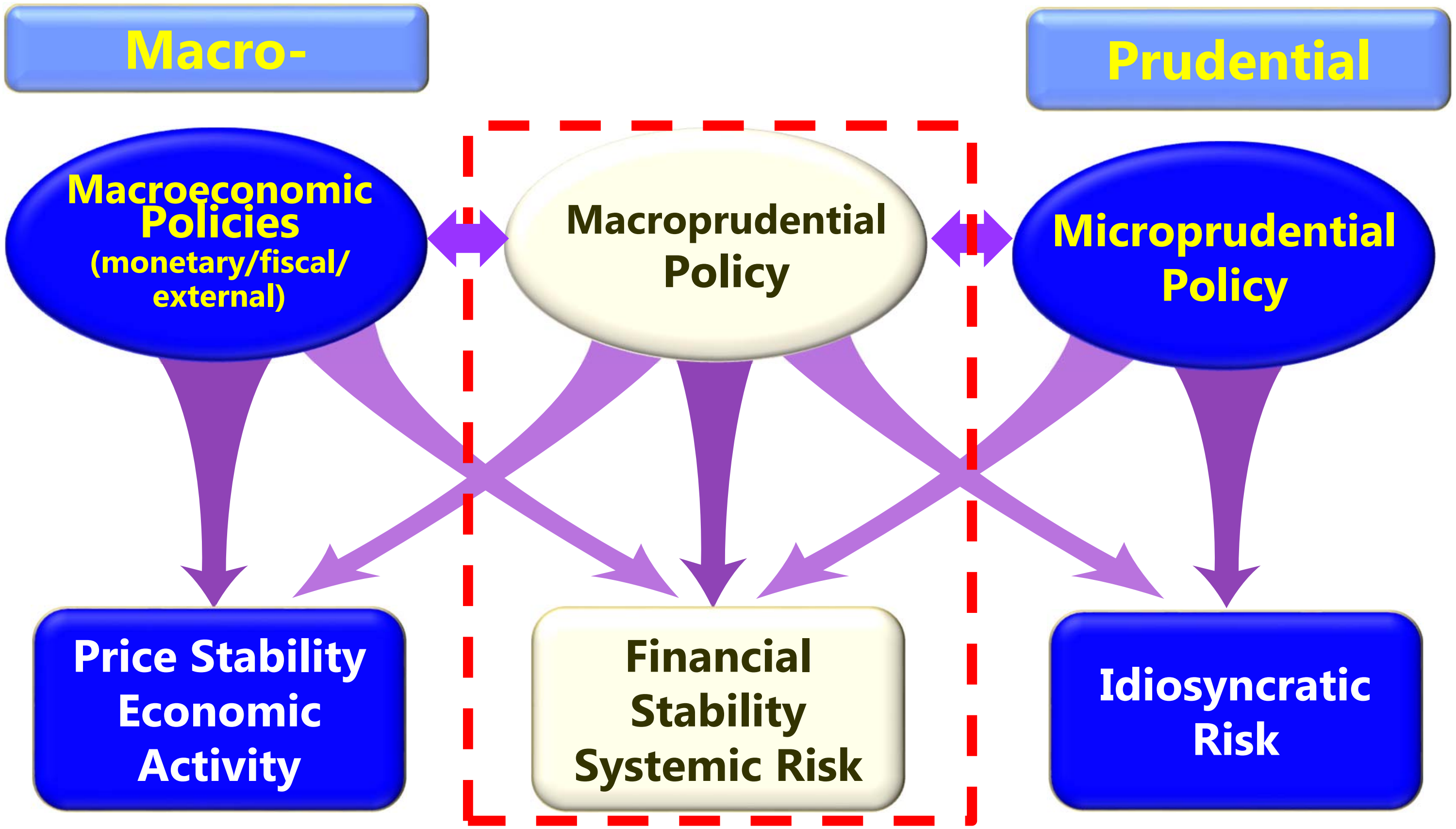
7. Financial structures affect stability (and growth)

   Should MaPs aim for a "preferred" financial structure?

"Old" framework of macroeconomic and prudential policies



"New" framework of macroeconomic and micro- and macroprudential policies



Issue 1: Finance is special, but can come with problems

- Finance is important to economic growth and other goals. **But**:
- Finance is **Procyclical**, subject to booms/busts, and crises
  - Runs often through asset values and leverage
- Finance displays much **Interconnectedness**
  - Contagion within financial system (eg, TBTF, common exposures)
- Procyclicality interacts with interconnectedness

➢ Calls for policy response, including macroprudential policies (MaPs)

Question 1: Why exactly are MaPs needed?

Microprudential, monetary, other policies do not suffice →MaPs

- But MaPs need justification
  - Externalities, market failures
  - To compensate for other policies, eg, microprudential (MiP), tax deduction
- Need better theory, esp. booms: short of a paradigm for MaPs
- Applies to both domestic and international dimensions (and thus also to capital flow management tools, CFMs)

Issue 2: As MaPs are being used, empirical evidence is accumulating

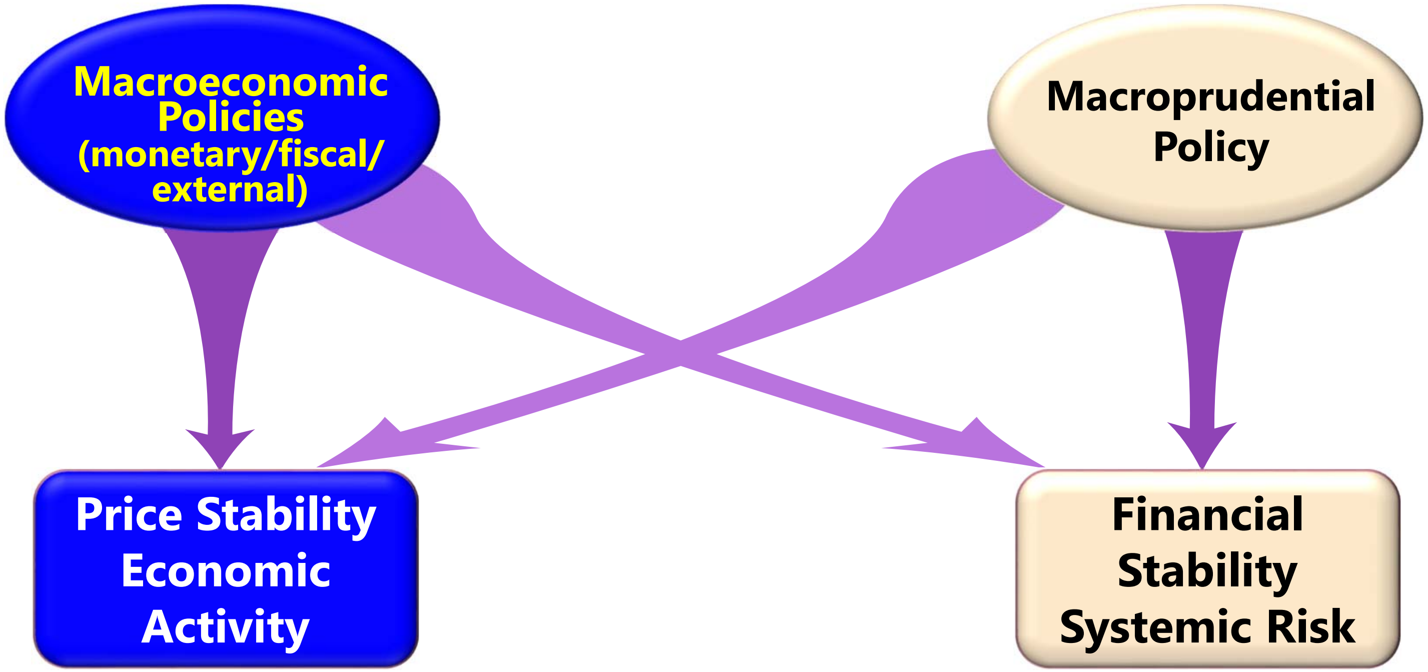
- More MaPs in place over time (advanced economies still less than emerging markets and developing countries)

- Evidence accumulating. So far:
  - Borrower-based ("LTVs", "DTIs"): Work for real estate, harder to circumvent. But can be politically "costly"
  - Financial institutions': Better known. But easier to evade. FI costly
  - All: Temporary cooling, but not always sustained, buffers seldom sufficient for busts. And need to differentiate by country and MaPs

Question 2: What are open empirical issues?

- Know too little on:
  - Rarely explicitly aimed at externalities/market failures
    - What are intermediate targets and effectiveness?
  - Interactions among MaP tools, with other policies (notably MiP)
  - Rules vs discretion. Calibrations (eg in busts). Adaptations
  - Costs, financial and economic
    - Side-effects. Potential new distortions. Evasion. Migration
    - Political risks
- Partly due to limited cases, data and research

Issue 3: MaP and monetary policy (MoP) may need to be coordinated



Question 3: How to coordinate MaP and MoP in practice?

- When policies operate perfectly, no major challenges
  - Complement each other, eg, phases of business and financial cycles overlap
  - Both: clear mandate, decision-making, accountability
- But constraints on one can imply the other has to do more
  - With imperfect MaP, MoP has to do some ("getting into the cracks")
  - With constraints on MoP (fixed exchange rate, ZLB), MaP has to do more
- <u>Yet:</u> much more work needed for clear-cut policy advice
  - How much to adapt each policy to the other? How to inform each other? How to coordinate? What is governance? Where does MaP best reside?

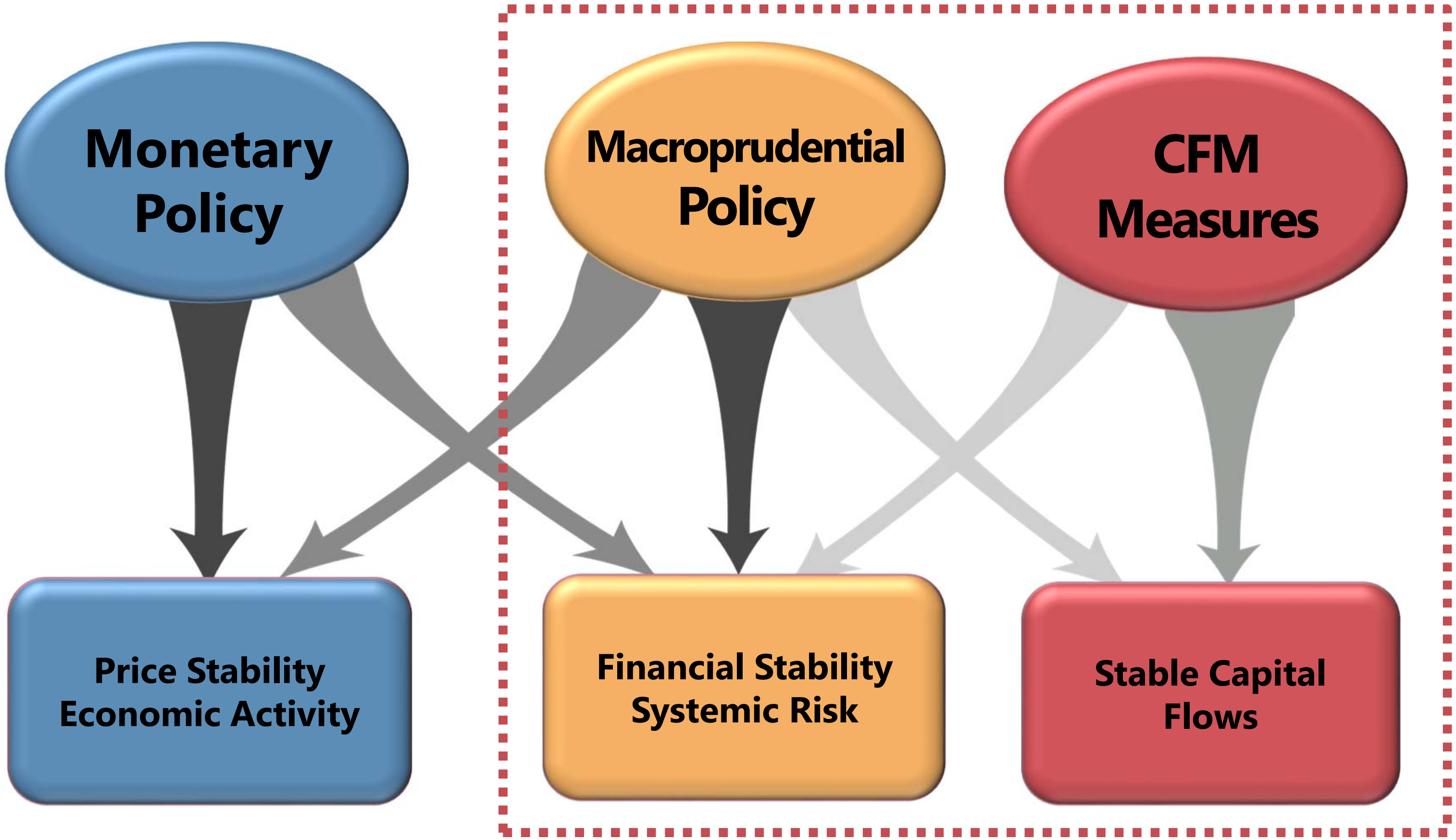
Issue 4: MaPs are used in a globalised world

- MaPs less effective in open economies
  - Higher use of MaPs → increases cross-border claims
- Globalisation, Global Financial Cycle: less control of domestic finance
- MoPs and MaPs hard to coordinate (gains small/uncertain, cooperation difficult, limited forums, or just ex-post, when in crises)

  → Need to consider MaPs together with CFM tools
- Challenges
  - Spillovers of MaPs, while generally small, very heterogeneous
  - Also MaPs less impact with more developed finance

    → More developed financial markets, tap alternatives, circumvent

Question 4: How to balance, coordinate MaPs and CFMs?



How to distinguish MaPs and CFMs? How to guide their use?

- Some distinctions between MaPs and CFMs
  - *Operational*: capital flows vs domestic finance
  - *Legal*: residents vs non-residents
- But also much overlap and both may be needed
  - Some MaPs can affect non-residents more, like CFMs
  - CFMs needed; where MaPs do not apply; or when MaPs distort
- So, how to guide use of MaPs and CFM?
  - Unilaterally. Relative to other tools, policies
  - <u>And</u> multilaterally. To assure open, efficient and stable system

Issue 5: Need to consider risks within non-bank markets

- Non-bank financing can be procyclical, create tail risks
  - Much of it built-in (eg margins, MTM, collateral)
  - Some of it tail-risk type (eg privately produced safe assets)
- Can have adverse real sector consequences
  - Fire-sales, asset price busts, recessions; booms leading to misallocations
- No comprehensive conceptual approach to such risks to date
- Challenges
  - Financial innovation: needs a dynamic, system view of risks and productivity
  - Instability of complex systems: needs new modelling, eg agent-based

Question 5: What is the best MaP approach for risks within non-bank markets?

- Regulate intramarket-based financing, using an activity-based approach?
  - Indirect, as in higher capital, liquidity for securities financing transactions?
  - Direct, as in minimum margins, early redemption fees, gates, limits on redemptions?
  - State-contingent policies, as in "through the cycle" rules, akin to CCyB?
    - Eg through the cycle margin and risk approaches

- Adapt mandates for regulators to allow non-bank system oversight?
  - How to adapt governance of toolkit? How to cover capital markets?
    - Cannot aim for full predictability, some ex-post, discretionary actions necessary
    - How to combine with need in capital markets for certainty, property rights?

Issue 6: Data on systemic risks is still incomplete, and market discipline on system is limited

- System-risk measures still incomplete
  - And vary greatly as scope, institutional coverage, methodology are not uniform
- Better use and more data needed
  - Improved measurement: start with better use of existing data
  - Even with significant progress using existing data, more data needed
- Markets cannot be expected to monitor system developments
  - Cannot rely solely on financial (investor) disclosure
  - Need better information on system risks, vulnerabilities
  - And better incentives to use these data

Question 6: How can market discipline complement MaPs?

- What data to collect and disclose (more)?
  - More on banks? Stress tests? Intra-financial system exposures?
  - Financial stability reports to include more of market activities?
    - Collect, publish margins, overall exposures?
    - Net or gross activities, stock or flows, including re-use?
- How to assure market <u>and</u> regulatory discipline complement?
  - How to allow <u>and</u> encourage for more analyses? What incentives for market participants to collect and use system information?
  - Would greater use of mutual insurance mechanisms help?

Issue 7: Financial structures affect stability (and growth)

- Financial system diversity affects financial stability
  - Crises more likely, recovery from busts worse for *bank-dominated systems*
    - Especially real estate booms and busts are bad
  - Diversity ("spare wheel") helps, for various reasons
  - But: Procyclicality over shorter run higher with *market-based financing*

P.S.

- Financial structures also affect growth, innovation, productivity
- Level of financial development can affect growth
  - Positive, but revisited: declining over time and maybe peaking at high depth

Question 7: Should MaP aim for a "preferred" financial structure?

- For greater financial stability, like to see →
  - Less bank-based, more markets, more diverse, less TBTF
  - Fewer perverse links banking ↔ shadow systems
  - Not much more volatility and procyclicality
    - Preferably also lower costs, more productive financing (less housing finance, more intangible, productive investments)
- Questions

1. Do regulatory trends support these objectives?
2. Is there a role for MaP?

Longer-run regulatory trends
Less structure and conduct; more disclosure, capital based

Structural Regulations		Conduct Regulations		Prudential Regulations	
Functional separation of institutions	↓	Regulations of bank's deposit and lending rates	↓	Deposit insurance	=↑
Entry restrictions	↓	Regulation of fees and commissions	↓	Discount window	=↑
Ownership restrictions	↓	Credit quotas	↓	Restriction on asset concentrations	↓=
Discriminatory rules against foreign investors	↓	Branching limitations	↓	Information disclosure	↑
				Solvency ratios	↑

How do MaPs fit in with other, recent “reversals” in regulatory trends?

“Structural” measures

- More formal separation
  - Vickers, Volcker, Liikanen, etc
- Derivatives on exchanges, CCPs
  - Explicit structure (+conduct) regulation
- Shadow banking
  - Less puts, regulatory arbitrage, higher costs for banks’ securities-financing

“Conduct” measures

- LCR, NSFR
  - Away from capital-based only
- Mutual funds, hedge funds, etc
  - MtM, NAV, redemption gates, fees, other approaches
- MaPs
  - Affect credit allocation, FIs

Overall: Many questions on system design and regulations, including for MaPs

- Ideally a system view that is more dynamic. "What delivers less systemic risks and procyclicality, and more productivity?" Examples:
  - If procyclicality of some financing a problem in one part, how not to migrate it where it becomes subject to regulation w/ same issues (eg, Solvency II)?
  - If liquidity risk is a major concern, how to move liquidity-sensitive to part of the system best able to absorb such risks (eg, limit reverse maturity)?
  - If systemic risk externalities are key, how to seek more "mutual insurance"? If through asset prices, then greater through the cycle capital, provisioning, etc…
  - If productivity is low, how to encourage "right" forms of financing, ie, not debt?
- General equilibrium and dynamics very hard. Still, more can be done, including with what role for MaPs

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