The challenge of taking macroprudential decisions: who will press which button(s)?

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Let me start by thanking the organisers for inviting me to this 13th Annual International Banking Conference. In my first visit to the Chicago Fed in 2002 I addressed the international conference on the policy implications of asset price bubbles. I spoke then of the Bank of Spain's response to the frothy property market, shortly after the Bank had required forward-looking provisioning. Today I would like to share with you some reflections on the very real challenge of making that type of call in terms of timing, responsibility and action – the type of call that the now popular macroprudential policy would call for.

Let me approach this challenge by posing four questions:

- What have we learned about the macroeconomic impact of prudential policy?
- How much macroprudential policy should be embedded in the regulation?
- How many macroprudential tools ("buttons") are there?
- Who should press these buttons?

But first, to put these questions into a broader context, let me try to summarise what the recent global financial crisis has taught us about the necessary conditions for financial stability.

1. The global financial stability framework: a summary

Financial stability can be maintained only within a global financial stability framework of shared responsibility. Macroprudential policy is only part of one of the four building blocks of that framework:[1]

- *Macroeconomic policies:* Both monetary and fiscal policy must lean against the winds of unusually rapid private credit growth and asset price increases.

[1] J Caruana, "Macroprudential policy: working towards a new consensus", remarks to the high-level meeting on "The emerging framework for financial regulation and monetary policy", jointly organised by the BIS's Financial Stability Institute and the IMF Institute, Washington DC, 23 April 2010.

- *Prudential policies:* Leaving aside their role in crisis management and in supporting a stronger financial infrastructure, prudential tools must be used to lean against the same winds as well as to reduce systemic risks across the financial system; regulatory policies must increase resilience by ensuring sufficient capital and liquidity buffers; and supervision must see that the rules are implemented efficiently and consistently.
- *Market discipline:* Market discipline must be restored with policies that support transparency and the presumption that nobody is too big to fail and that the burden of failure is shared by both equity *and* debt holders before public funds are used;
- *International cooperation:* We must work together under the principle that it is not enough to keep one's own house in order.

With this in mind, I now turn to the first of my four questions.

2. What have we learned about the macroeconomic impact of prudential policy?[2]

Today, we are less in the dark as to the impact of certain kinds of macroprudential policy. This is thanks to the work that has been done in connection with the Basel Committee on Banking Supervision's proposal to strengthen capital and liquidity standards. In the past, the target level of capital *for the banking system as a whole* has been determined purely by looking at the appropriate level for individual institutions, on a bank by bank basis, and then aggregating up. Similarly, Basel II was calibrated with the constraint that the overall level of capital in the system, as determined in previous regulatory reforms, should not change. Now, for the first time, the calibration of capital and liquidity requirements and their pace of implementation are also being informed by top-down macroeconomic studies that examine the impact of the proposed standards on output. In the process, we are beginning to learn about how regulatory changes affect the course of credit and output over the cycle. This could pay dividends when the time comes to use macroprudential tools more actively.

I commend to you the reports of the Macroeconomic Assessment Group and the Long-term Economic Impact Group, which were published in mid-August.[3] The first focused on the near-term costs of the transition to stronger capital and liquidity standards; the second focused on a comparison of steady states, taking into account the benefits from a reduction in the likelihood of banking crises. To be sure, these reports will not be the last word on the subject. They should spur development of macroeconomic models capable of better integrating the financial and real sides of the economy.

Taking the two reports together, three conclusions emerge strongly.

- First, given an adequate transition period, the economic benefits of a strengthening of capital and liquidity standards outweigh the costs.

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2 This section does not consider what is being learned from the experience in individual countries with macroprudential policies. See below under "How many buttons?".

3 Financial Stability Board and Basel Committee on Banking Supervision Macroeconomic Assessment Group, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements - Interim Report*, and Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010.

- Second, these economic benefits, which take the form of a lower likelihood of crises, accrue immediately, not just in the long run.
- Third, the results suggest that, by making the financial system more resilient to shocks, countercyclical capital standards can help to dampen the business cycle, especially the fall in output associated with a defensive contraction of credit.

That said, this work is just a starting point in the systematic analysis of the link between prudential regulation and the macroeconomy. Uncertainty regarding the models and impact has been fully taken into account in the agreement on a long transition period.

3. How much macroprudential policy should be embedded in the regulation?[4]

Or, to put the question differently, how far can macroprudential policy rely on rules embedded in regulation as opposed to discretion in supervisory decisions? "As much as possible, but no more", I would say. Given uncertainty regarding low-probability events entailing high costs, it is difficult to press the button, particularly in good times. That said, an internationally agreed framework can help the authorities to exercise and to justify discretion. As an illustration, let me focus on measures to make prudential standards less procyclical (the time dimension of the macroprudential approach). Given the limited time available, I omit those that address common exposures and interconnections as sources of systemic risk (the cross-sectional dimension).

The Basel Committee on Banking Supervision seeks to embed in regulation the macroprudential principle of increasing capital buffers in good times that can be drawn down during periods of stress. Two capital buffers have been endorsed by the Governors and Heads of Supervision.

First, there is a proposal to conserve capital.[5] This conservation buffer above the minimum requirement is purely rule-based, as it is set as a fixed proportion of risk-weighted assets. The buffer can be run down during a period of stress, lessening pressure to restrict credit. But its primary objective is to ensure that banks that incur losses and thereby, with realistic accounting, approach the minimum do not pay out capital, which would further deplete their reserves. During the crisis, most of the banks continued to make distributions at the accustomed, blue-sky rate, paying dividends and bonuses and repurchasing shares. This buffer is best thought of as a microprudential tool with macroprudential implications, since it would leave the system more resilient as a downturn deepened.

Second, there is an additional countercyclical buffer.[6] This tool is much more based on discretion. Through similar restrictions on dividend payments, banks would be constrained to accumulate this buffer during periods of very rapid credit growth in order to mitigate the build-up of systemic risk. Supervisors would then release the buffer as strains materialised in order to absorb losses. The ratio of credit to GDP would serve as a common reference for the

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[4] In addition to the measures described below, the Basel Committee has also proposed that the minimum capital requirement be made less procyclical by using probability of default estimates from bad times, rather than good times. This would keep the minimum from ratcheting up in bad times. Also, the Basel Committee is working with the International Accounting Standards Board on the expected loss approach to loan loss provisioning.

[5] Basel Committee on Banking Supervision, "Strengthening the resilience of the banking sector – consultative document", December 2009.

[6] Basel Committee on Banking Supervision, "Countercyclical capital buffer proposal – consultative document", July 2010; M Drehmann, C Borio, L Gambacorta, G Jimenez and C Trucharte, "Countercyclical capital buffers: exploring options", *BIS Working Papers,* no 317, July 2010.

build-up phase – indicating when to push the button. But it would not establish a hard-and-fast rule. Authorities would be allowed to rely on a broader set of indicators, including, for instance, asset prices. And a set of principles would guide its release, based on indicators of emerging strains. Given the uncertainties involved, it has not proved possible to reach agreement on a simple rule. Inescapably, judgment remains critical in this case.

The operation of this countercyclical buffer requires a decision to act. Let me offer a perspective on the very real challenges involved by harking back to my last appearance here at the Chicago Fed and recalling what was on the Bank of Spain's dashboard when we decided to require dynamic provisioning based on through-the-cycle parameters.

The context was that of a new currency union. The virtual euro had replaced the peseta at the beginning of 1999. Interest rates in Spain had converged to European levels well before then. There was a strong prospect that the macroeconomy would be more stable, supporting the servicing of higher debt. The interest rate sensitive sector of the economy was responding vigorously and real estate prices were recovering from lows reached in an earlier cycle. By 1999–2000, mortgage credit was growing at 15% per annum and house prices were rising at about 10% per annum. With inflation above the European average, and even with real growth at 5%, rapid credit growth amid keen competition in the financial sector was a cause for concern.[7] Because of the euro, the interest rate was not an available tool. Macroprudential policy was the only possible option.

Contrary to the view that the authorities will inevitably identify a potential problem too late, the Bank of Spain identified the build-up of risks very early: the peak in property prices did not occur until 2007. Early identification is very good from the perspective of building buffers, but it poses a number of problems from the perspective of signalling and communication. When the authorities respond to risks that do not materialise for years, the inevitable controversy and criticism about the measures taken can undermine their effectiveness, which partly depends on acceptance of their rationale. Thus, timing the call is difficult, and from the communication perspective there are risks of making it either too early or too late. Dynamic provisioning did make banks stronger than would otherwise have been the case, and there is some suggestive evidence that it moderated the credit boom as well. Whether the Bank of Spain's response was proportional to the challenge, or more should have been done, remains a matter of debate.

Regardless of the final outcome, this was not an easy call. Banks were not pleased to report reduced profits as they built up their statistical loan loss provisions. Provisioning that cost around 20% of operating profits and that was not required of international peers did not go down easily. In addition, there were technical challenges from the accounting profession, incorrectly concerned with artificial profit smoothing. It will never be an easy call: uncertainty will be high, and therefore explaining the trade-offs to set reasonable expectations will be key. An internationally agreed framework for the countercyclical buffer can only help the authorities. But the onus to push the button remains on them.

4. How many buttons?

In addressing procyclicality, Basel III has made capital and liquidity its anchors and has refrained from targeting specific sectors. However, the range of macroprudential tools is

[7] J Caruana, "Banking provisions and asset price bubbles", in W Hunter, G Kaufman and M Pomerleano (eds), *Asset price bubbles: the implications for monetary, regulatory, and international policies,* Boston, MIT Press, 2002, pp 537–46. See also J Caruana, "Monetary policy, financial stability and asset prices", *Documentos Ocasionales*, no 0507, Bank of Spain, 2005.

wider and much practice to date by central banks has focused on particular sectors.[8] For example, several years ago the Reserve Bank of India raised the Basel weights for household loans, as well as mandating higher loss reserves, in the face of rapid growth of household credit. Other sectoral policies have sought to constrain the extension of credit or to protect against a decline in asset prices, rather than to require more capital to back credit. For instance, in the face of a rapid rise in mortgage debt and house prices, authorities have sought to prevent the usual deterioration of underwriting standards by imposing or lowering maximum loan-to-value ratios. A similar policy, proposed by the CGFS, would be to promote greater stability in haircuts in securities markets.[9] Sectoral policies can be very helpful complementary tools in a macroprudential toolkit. In using them, however, we should also beware of drifting back inadvertently to credit allocation.

5. Who will press the button?

I have underscored the difficulty in practice of pushing the button. This means that the governance arrangements for financial stability are critical.[10]

The governance of macroprudential policy has to build on central banks' strengths, rely on ex ante clarity about roles, responsibilities and powers, safeguard operational autonomy and draw on international cooperation. Let me unpack this statement.

- Central banks should play a key role in macroprudential policy given their natural *strengths*: their expertise in macroeconomic analysis; their intimate knowledge of, and active participation in, financial markets; their role as lenders, and possibly market-makers, of last resort; and their oversight of payment and settlement systems.
- *Ex ante clarity about roles, responsibilities and powers* is key to ensure effective and timely decisions; careful management of the inevitable and difficult trade-offs; and, ultimately, accountability. Powers must be commensurate with mandates. Accountability for decisions can be achieved by disclosing information to the public or in reviews by the legislature. The difficulty of setting out measurable financial stability objectives makes accountability more complicated, so clarity about the strategy, actions and the decision-making process can make this form of disclosure meaningful.
- A degree of *operational autonomy* from government should help macroprudential authorities take restraining actions during booms, by shielding them from political economy pressures. A key role for central banks has the advantage of bringing their established independence to the table. At the same time, it is essential that involvement in macroprudential policy does not compromise central banks' autonomy, including their financial independence. In particular, they must retain control over their balance sheet and be shielded by clear arrangements to share losses with fiscal authorities. Arrangements must protect the central bank's autonomy from market

8 Committee on the Global Financial System, "Macroprudential instruments and frameworks: a stocktaking of issues and experiences", *CGFS Papers*, no 38, May 2010. See also J Caruana, "Macroprudential policy: what we have learned and where we are going", keynote speech at the Second Financial Stability Conference of the *International Journal of Central Banking*, Bank of Spain, Madrid, 17 June 2010.

9 Committee on the Global Financial System, "The role of margin requirements and haircuts in procyclicality", *CGFS Papers,* no 36, March 2010.

10 J Caruana, "The great financial crisis: lessons for the design of central banks", speech at the Colloquium in honour of Lucas Papademos, European Central Bank, Frankfurt, 20 May 2010.

participants with an immediate business interest in the conduct of financial stability policy.

- Finally, *policymakers must cooperate across countries*. For instance, countercyclical capital buffers need to respond to national macroeconomic and financial developments. But large banks span a number, in some cases a large number, of national markets. As a result, the Basel Committee envisions establishing a senior group to discuss national decisions to require such buffers. The purpose of the group would be to share the logic used in taking such decisions and thereby to distil best practices. Even banks based in a country with sound finances can be rendered unstable by exposures elsewhere. At the level of the FSB a number of processes, including peer reviews, will also help to increase cooperation and consistent application of measures.

In conclusion, let me revisit my four questions.

- First, thanks to the hard work of scores of analysts, we now have a new top-down perspective on how prudential rules affect the real economy. This is real progress, though we must and will do better in modelling this relationship.
- Second, Basel III represents a big step forward in its adoption of macroprudential overlays in regulation. These overlays should rely as far as possible on rules, but discretion will be needed and decisions will be difficult and controversial. Paraphrasing Keynes' dictum that markets can stay irrational longer than you can stay solvent, markets can stay on an unsustainable course longer than countermeasures and their rationale can stay convincing and credible, especially if you set expectations too high.
- Third, a number of macroprudential buttons already exist and the range is being expanded, although, as I said, caution is required on this front;
- Fourth, the governance of macroprudential policy has to build on central banks' strengths, rely on ex ante clarity about roles, responsibilities and powers, safeguard operational autonomy and draw on international cooperation. When the time comes to push the button, any lack of clarity as to whose finger does the pushing can lead to delay precisely when a timely response is needed.