

Getting effective macroprudential policy on the road: eight propositions

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Introduction

It is widely agreed that effective macroprudential policy needs to be part of the stabilisation policy arsenal. Macroprudential policy aims to limit systemic risk, primarily by regulating financial institutions. Its rationale is that individual financial firms can create negative externalities for other parts of the financial system and these externalities can threaten the stability of the financial system as a whole, even if individual firms appear sound.

The challenge now is to translate these abstract imperatives into practical operational frameworks. In doing so, policymakers must judge which framework elements most need development. Much of the literature on macroprudential policy describes obstacles relating to analytical gaps, institutional limitations and political economy.² This paper's contribution is to assess progress in overcoming the obstacles and to suggest priorities for development.

The elements of any policy framework are an objective, diagnostic tools, instruments, an operating strategy, and governance arrangements. Many examples of these elements now exist.³ Some observers see the macroprudential technology, especially the diagnostic tools and instruments, as lacking.⁴ We instead suggest that it is not individual framework elements themselves, but their integration in a way that resonates with the public, which most needs attention. There should be an explicit macroprudential mandate, an operating strategy that includes leaning against the financial cycle, centralised and transparent decision-making, and simple communication of policy decisions linked clearly to systemic risk assessments.

A coherent and easily understood integration – a core policy narrative – will be essential for building a durable political constituency for financial stability. Such a constituency will be especially important as memory of the crisis fades and as policy errors and misjudgments are inevitably made. Public understanding of the framework might also bolster its effectiveness by promoting stabilising expectations.

In the rest of this paper we articulate this argument more precisely, in the form of eight propositions about the focus of the development work needed. We discuss the technology first and then move to institutional and communications matters.

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² See, for example, Borio and Shim (2007).

³ Oosterloo and de Haan (2004) survey central banks' duties regarding financial stability. Cihak (2006) reviews financial stability reports. BIS (2010) discusses experience with macroprudential measures.

⁴ See, for example, Volcker (2010) and Haldane (2010).

Eight propositions about effective macroprudential policy

Proposition 1: Existing indicators can support effective systemic risk diagnosis.

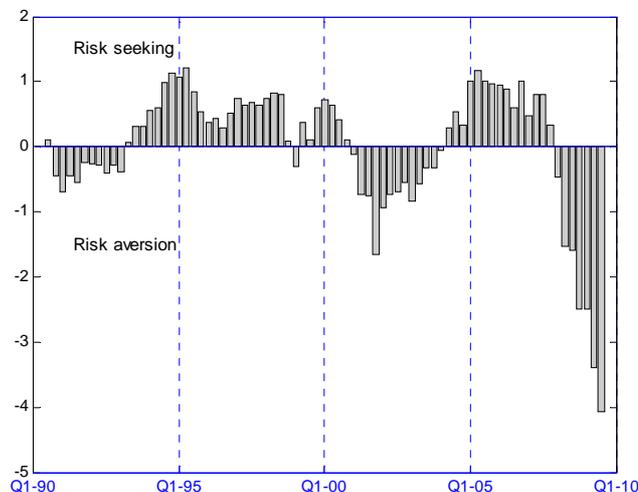
A substantial body of research studies the evolution of systemic risk factors, measured at a fairly aggregated level, over time. Newer research links systemic risk to more disaggregated factors such as common exposures and financial system interlinkages.⁵ In either case, policymakers need to know how reliably the indicators can predict financial crises or major output fluctuations. At the aggregate level the evidence is better established. Above-trend aggregate credit and asset prices, for example, can predict crises reasonably well.⁶

For diagnostic purposes it helps that the many systemic risk indicators seem mostly to be positively correlated. This correlation suggests that there is an underlying “financial cycle”, or ebbing and flowing of general risk sentiment. Figure 1 illustrates with a financial cycle indicator for the United States, constructed as the first principal component (PC) of a diverse range of variables variously cited as measures of risk-seeking.⁷ This PC has a correlation coefficient of 0.7 or 0.8 with most of the underlying indicators and explains around half their total variance, suggesting that it is indeed picking up a generalised financial cycle.

The concept of the financial cycle is similar to “financial conditions” examined in other empirical work,⁸ with the key difference that our indicator excludes variables that would be heavily influenced by monetary policy. Financial conditions indices summarise all influences on the general cost and availability of funding, whereas the financial cycle measure is intended to extract the contribution to systemic risk of the private financial sector.

Figure 1

A composite financial cycle indicator for the US



Source: authors' calculations.

⁵ See Galati and Moessner (2010) for a review.

⁶ Borio and Drehmann (2009).

⁷ Variables used were real house price inflation, real equity price growth, the gap between 10-year and five-year government bond yields, the junk-to-government spread, commodity price inflation, bank lending standards, the loan-to-deposit ratio, and bank lending growth. Full details are available on request.

⁸ See eg Hatzius et al (2010).

Proposition 2: Suitable and familiar instruments exist and should be used.

Many instruments suitable for macroprudential use are available and familiar from traditional microprudential policy. Hard limits can be imposed on the risk associated with specific activities, such as loan-to-value (LTV) or debt service ratios, currency mismatches or sectoral credit concentrations. Or, risk-taking by financial institutions can be influenced more generally through capital or liquidity requirements.

There are many instances of interventions of the specific sort, particularly in emerging economies. For example, several Asian economies have used LTV ratios for the past decade or so to protect their banking systems from property market downturns.⁹

The Basel III capital framework includes as macroprudential instruments a countercyclical capital buffer, higher loss absorbency for systemically important banks, and a leverage ratio.¹⁰ New tools are also being developed in response to the problems associated with shadow banking and wholesale funding markets during the crisis.¹¹ While of course one should be open to the possibility of new and better tools in the future, building the toolkit now around readily available and familiar tools would limit the risks associated with novel instruments.

Proposition 3: Policymakers should operate instruments to lean against the financial cycle as well as applying fixed limits to risk-taking.

Policymakers can either leave the instrument settings mostly fixed over time, or actively adjust them to anticipate and counteract (that is, lean against) the financial cycle. Fixed settings are technically simpler, but they cannot guarantee that systemic risk will be acceptably constrained under all circumstances. Policymakers therefore need to monitor emerging developments and to be prepared to adjust the settings if necessary.

Diagnostic efforts supporting a leaning strategy should focus on the risky behaviour during upswings, rather than waiting for signs of actual deterioration in financial strength. By the time these signs appear, it will probably be too late to act. Moreover, financial strength could well be overstated towards the end of upswings, due to procyclicality in mark-to-market accounting practices and optimistic risk modelling.

Tightening when things seem to be going well will not be popular. And to be fair, genuine positive productivity shocks often underpin rising asset prices and credit early in the financial cycle. The diagnostic issue is identifying the point when risk-seeking rather than economic fundamentals become the main driver of the financial upswing. This point necessarily occurs before traditional indicators of balance sheet robustness start turning.

Proposition 4: The macroprudential mandate should be explicit.

Explicit mandates bolster policymakers' legal and moral authority to take unpopular actions. They also clarify, even for regulatory staff themselves, who is doing what and why. Mandates help resolve principal/agent and communications problems if the macroprudential agency also takes microprudential or monetary policy decisions, if some officials are involved in decisions in more than one policy area, or if different policy functions use the same type of regulation (for example, capital requirements).

⁹ Similarly, CGFS (2010b) proposes the use of minimum margin requirements as a means to manage risks in wholesale funding markets.

¹⁰ See BCBS (2010).

¹¹ See CGFS (2010a) for more detail.

Jurisdictions across the world are increasingly issuing explicit and high-profile mandates for macroprudential policy. In the United States, United Kingdom and European Union, for example, these mandates have the force of statute. The US and UK examples appear most specific in pointing to “leaning” strategies. The US text includes a function “to respond to emerging threats to ... [stability]”, while the UK highlights “damping the credit cycle”. The EU case is less specific in requiring the authority to “allow for risk assessments to be translated into action by the relevant authorities”.¹²

Independence of the macroprudential decision-making from the political process strengthens the moral force of mandates. The composition of the UK macroprudential committee appears to emphasise independence most strongly (Table 1). The Treasury is present, but non-voting. The United States is at the other end of the scale, with the Treasury chairing the committee. The European Union is in the middle, with the European Commission supplying a voting member and the EU Economic and Financial Committee a non-voting member.

Table 1
Macroprudential authority membership and powers

Authority	Membership	Powers over instruments
UK Financial Policy Committee	Chair: central bank/supervisor governor. Officials from: central bank/supervisor, consumer protection and markets regulator, external members. Non-voting: Treasury official.	Direct powers
EU European Systemic Risk Board	Chair: central bank governor. Officials from: ECB and national central banks, European Supervisory Authorities, European Commission. Non-voting: EU ECOFIN Committee representative, others.	To issue comply-or-explain recommendations
US Financial Stability Oversight Council	Chair: Treasury Secretary. Officials from: central bank/supervisor, other supervisory agencies, consumer financial protection agency, markets supervisor, deposit insurer, commodities regulator, housing finance agency, insurance expert. Non-voting: various.	To issue comply-or-explain recommendations

Sources: HM Treasury (2010); Commission of the European Communities (2009); US Congress (2010).

Proposition 5: Decision-making should be centralised, but draw on a broad range of information.

Since macroprudential policy is system-focused, its decision-making should be centralised in an identifiable agency that has full control over the macroprudential instrument(s).¹³ In cases where another authority also uses the same type of intervention, such as a capital requirement, the macroprudential agency should have full authority to apply its own requirement on top of that of the other agency. Such centralisation sends supervised firms clear and uniform messages, and simplifies international coordination.

¹² Sources for legislative provisions are listed in the Note to Table 1.

¹³ A clear analogy can be drawn with monetary policy, in which a single interest rate is clearly and unambiguously set by a single agency.

Centralisation of decision-making does not imply centralisation of information-gathering. On the contrary, supervisory information and market intelligence about risk-taking or herding behaviour in the upswing could be key evidence supporting early action. The US, UK and EU approaches all involve a wide variety of financial agencies in decision-making, including at least the central bank, supervisors and securities regulators (see Table 1). However, the degree of centralisation of decision-making power varies significantly across the three cases. The UK committee can give directions regarding instrument settings, whereas the US and EU committees can issue comply-or-explain recommendations only. The comply-or-explain approach decentralises decision-making to the regulators receiving the recommendations, thus leaving open whether a recommended macroprudential intervention will be applied evenly across the financial system.

Proposition 6: Policymakers need political support to tighten during upturns.

Like any forward-looking policy, macroprudential policy must deal with noisy signals. Among other things, noisy signals create a bias against tightening during financial upswings. A partial solution is to link instrument settings to reliable risk indicators where available, to help create a presumption of policy action during the upswing. Few indicators, though, can be expected to send unambiguous signals early in the cycle.

Moreover, noisy signals imply diagnostic errors and policy mistakes. Mistakes threaten the political acceptance and therefore also the durability of the macroprudential regime. The inevitability of mistakes and errors underlines the importance of dealing with political problems at source, by building a constituency for financial stability.

Proposition 7: Macroprudential policy cannot eliminate the possibility of crises.

The inevitability of policy mistakes also means that crises will happen again. This reinforces the need for the public to understand the rationale and limitations of macroprudential policy. It also means that three policy areas complementary to macroprudential policy will remain perennially relevant. First, the financial system infrastructure needs to be strong. Second, procyclicality due to accounting and microprudential policy standards needs to be reduced as much as possible. Third, tools to manage crisis and financial failure need to be effective.

Proposition 8: Macroprudential communications should be simple.

The technical and political economy challenges of macroprudential policy underline the essential role of effective communication. It is needed to counteract the bias against tightening during upswings and to build a long-lasting constituency for financial stability that understands the limits of policy. Influencing financial behaviour systemically also depends on simple policy communication. Well-informed public discourse could then strengthen the efficacy of policy by promoting the stabilisation of expectations and the legitimacy of the regime.¹⁴

However, getting the public discourse right will not be easy. The costs of intervention can be easily highlighted, but the benefits of limiting the risk of crises are much less tangible. The core policy narrative must therefore express the link from systemic risk diagnosis to instrument settings clearly and logically using straightforward concepts.

Monetary policy communication offers a model. Its core policy narrative is that if aggregate demand runs ahead of aggregate supply, inflation will rise, and the central bank will hike the

¹⁴ See Haldane (2010) for an elaboration of this argument.

policy rate. This idea is widely understood as the way in which low and stable inflation is maintained. Monetary policy in practice is of course more complicated, but the narrative is nevertheless close enough for useful public dialogue about monetary policy to ensue.

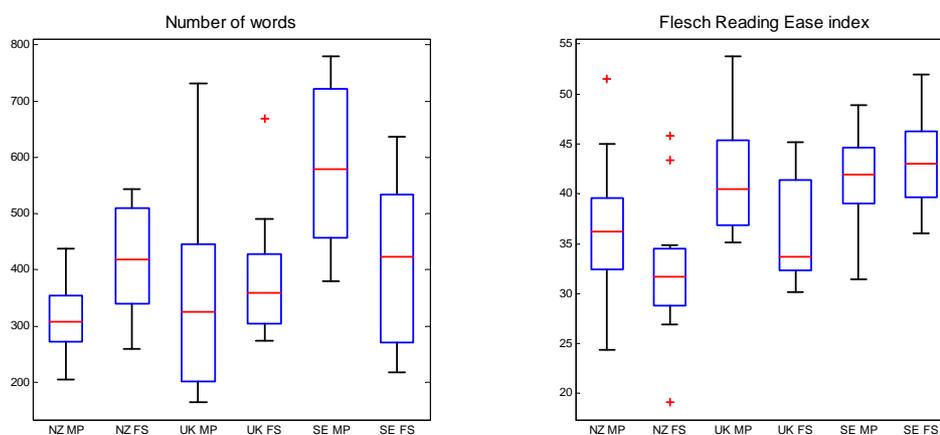
A core macroprudential policy narrative can be readily constructed around the analytical materials reviewed above. Ease and coherence of communication is another reason why we advocate building the young regime around a small number of fairly familiar risk concepts and instruments already in use.

Communications about financial stability do currently exist, of course, but they need to be adapted to a world with policy instruments and mandates for action. They also need to be made more accessible. Even with their relatively narrow focus on the diagnosis part of the narrative, the typical contemporary financial stability communication could be simpler.

As examples, we compared the financial stability and monetary policy press releases of three central banks recognised for their transparency of monetary policy: the Reserve Bank of New Zealand (RBNZ), the Bank of England (BoE) and the Swedish Riksbank. Graph 2 shows, for the period 2005–10, the word count and Flesch Reading Ease index (FRE) for press releases accompanying official interest rate decisions and Financial Stability Report (FSR) disseminations. The FRE summarises how difficult a text is to read, penalising sentences with many words and words with many syllables, such that a lower FRE indicates greater reading difficulty.¹⁵ The RBNZ seems to have the most work to do, with its financial stability releases noticeably longer and harder to read than its monetary policy releases.

Graph 2

Length and reading ease of monetary policy and financial stability press releases



Source: authors' calculations.

The relative accessibility of central banks' more specialist-oriented communications in each field is similarly contrasting. Inflation reports (IRs) tend to be shorter and to have an economically logical structure that essentially follows the lines of the core policy narrative. By

¹⁵ See the explanation of the FRE in Flesch (1951), cited in Harding (1967, p 41). Full details are available on request.

contrast, FSRs currently tend to be very long and dense, with many dozens of charts and tables, and, to our minds, with less of an obvious organising principle.¹⁶

Encouragingly, recent empirical work suggests that FSRs do influence financial conditions.¹⁷ Policymakers already spend considerable effort trying to use communications to influence risk-taking. And, thorough conjunctural documentation serves to show that the central bank's policy decisions have involved careful deliberation. This contributes to stabilisation by promoting credibility and legitimacy and by providing expert opinion, which assists private-sector decision-making. When the diagnostic material in current communications becomes clearly and expressly linked to current or likely future policy actions pursuant to explicit mandates, the communications might well become more effective.

Conclusions

This paper has surveyed a wide range of issues involved in getting practical macroprudential policy on the road with a reasonable chance of working. The technology available is not the biggest obstacle. Building a constituency for financial stability that understands the diagnostic difficulties and technical limits is both materially more urgent and essential to the durability of the framework as memory of the crisis fades.

The policy problem needs to be simplified into a core narrative simple enough to engage the public. The core narrative can be readily constructed by emphasising the relatively familiar parts of the framework and linking diagnosis to action.

Monetary policy communications offer a model. In that case, relatively simple communications have helped embed the policy regime and enabled expectations management to improve the effectiveness of the regime.

To develop the core macroprudential policy narrative further, we suggest the following priorities.

- The financial cycle should be defined and measured better, and modelled jointly with macroeconomic variables.
- For now, instruments should be based on familiar tools such as capital and liquidity ratios and LTV limits.
- A centralised authority should fully control the policy instruments under a clear mandate.
- Communications need to be clarified, while avoiding the impression that the risk of crises can be eliminated.

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¹⁶ See Cihak (2006) for a review of FSRs and comparison to IRs.

¹⁷ Born et al (2010).

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