Remarks on macroprudential policy frameworks

David Longworth[1]

I would like to thank the organisers of this conference for inviting me to participate in this panel. It is obvious from this conference that central banks continue to be the leaders in the development and discussion of macroprudential regulation and policy.

"Every financial crisis is the same."

"Every financial crisis is different."

Both are "true" in their own way. As Kindleberger wrote in his famous book on financial crises, "For historians each event is unique. In contrast economists maintain that there are patterns in the data and particular events are likely to induce similar responses."[2] Policymakers should focus mostly on what is "the same," as Tim Ng argued this morning.[3] Like historians, however, they cannot neglect what is unique because (i) our economic theories may not capture all that is relevant and (ii) the details may – if examined in the light of the aggregates – help us to understand what is going on.

I want to argue today that the need to be aware both of the similarities and differences in financial cycles and crises has implications for macroprudential policy.

In particular, it has implications for:

- The framework for macroprudential policy;
- The governance of macroprudential policy;
- Cross-cutting policy issues which are of relevance to macroprudential policy, monetary policy, fiscal policy and consumer protection. I will illustrate this final point by a look at the area of housing and housing finance.

I will begin with implications for the framework of macroprudential policy. I like to think of the heart of this framework as being illustrated in the following diagram (Figure 1).

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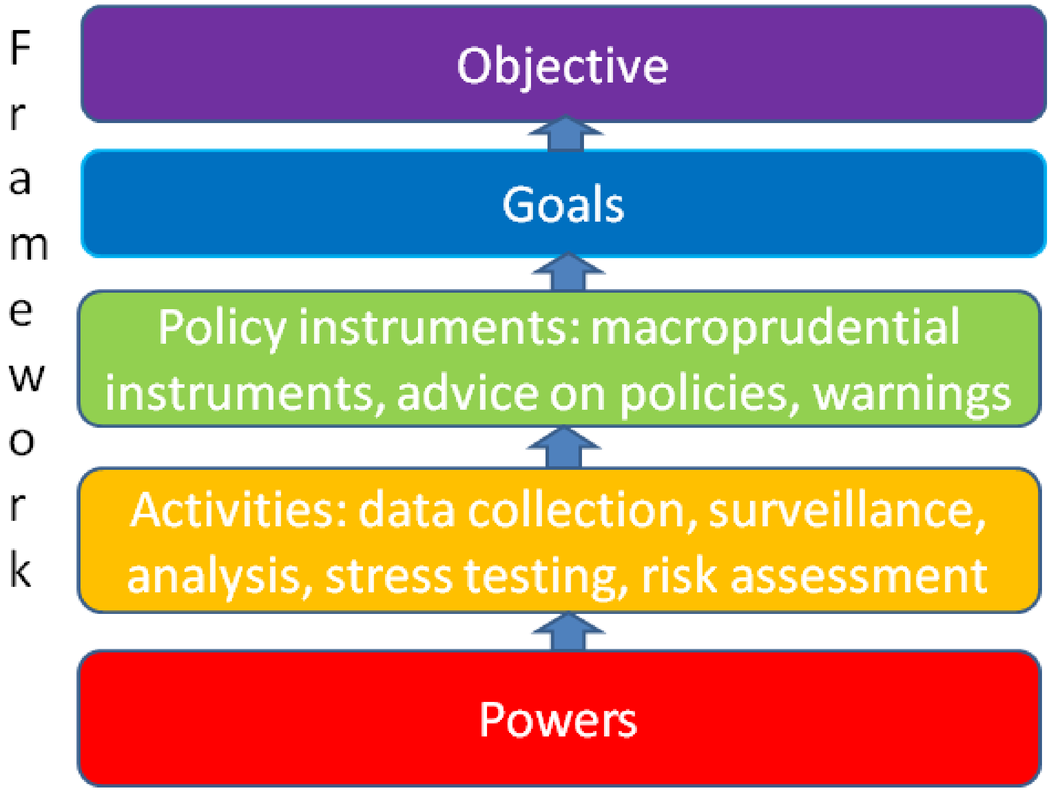
1 Adjunct Research Professor, Carleton University; John Weatherall Distinguished Fellow, Queen's University; Fellow, C D Howe Institute.

2 C Kindleberger and R Aliber, *Manias, Panics, and Crashes*, John Wiley & Sons, 2005, fifth edition.

3 Ng made these comments in his presentation of D Domanski and T Ng, "Getting effective macroprudential policy on the road: eight propositions", this volume, 2011.

Figure 1



The legislature grants certain powers to a macroprudential authority, which may be a committee, a standalone agency or a central bank. These powers allow the authority to undertake certain activities and to use certain policy instruments to attain certain goals. Attaining these goals will help it to achieve an objective such as having a low probability of financial disruptions in the economy.

Today, I would like to focus on the elements of the framework having to do with activities and policy instruments. The key activities for a macroprudential authority are data collection, surveillance of the financial sector, analysis, stress-testing of the sector and risk assessment. Based on those activities – particularly risk assessment – and given its goals, the macroprudential authority uses the policy instruments at its disposal. These will typically take the form of macroprudential instruments, advice on policies to individual regulators or to the government, and warnings to regulators or financial system participants. Of course, the macroprudential instruments may not be under the direct control of the macroprudential authority, but it may have the power to direct their use by others or to issue “comply or explain” orders.

Because of the sameness of financial cycles and financial crises, there must be an essential element of data collection that focuses on important credit aggregates, important asset prices, important interconnections between financial institutions and common exposures of financial institutions – especially exposures that are growing rapidly. An important element of surveillance, analysis, and risk assessment must also focus on these. Benchmarks for countercyclical macroprudential tools will typically be derived from historical studies of the behaviour of credit aggregates and important asset prices.

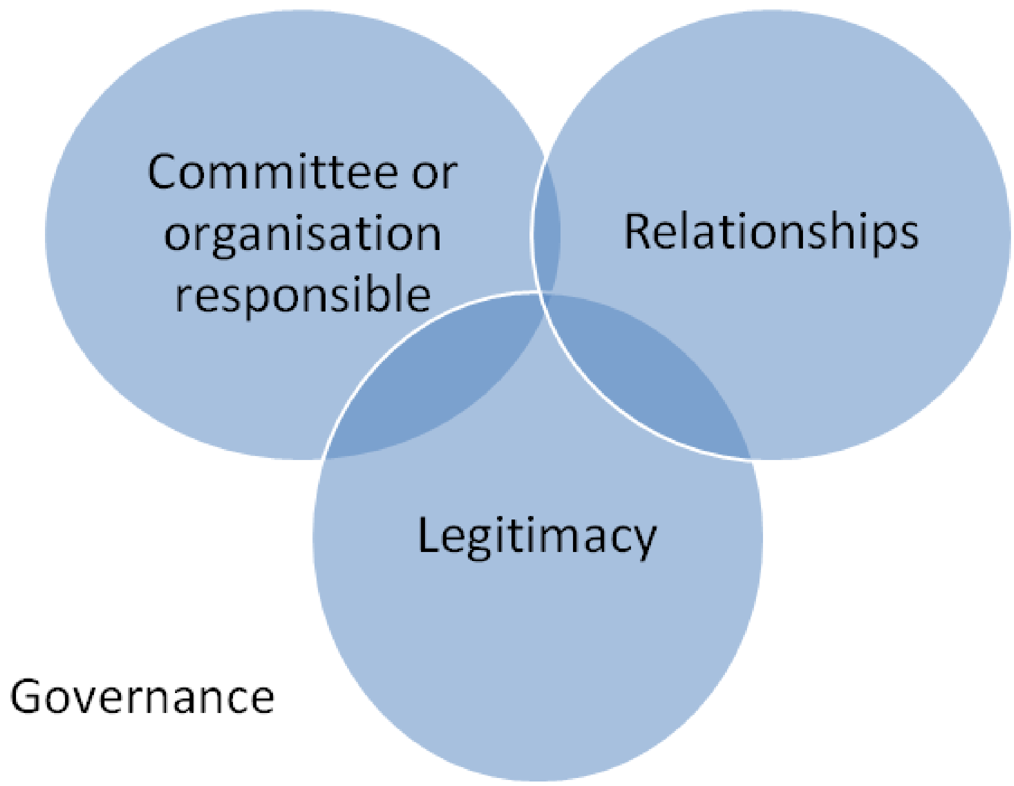
Because of the uniqueness of financial crises, however, there will be another important element of data collection that focuses on what is happening because of financial innovation and, perhaps, changes in regulation. There will be new instruments, new products, and new procedures to track. Again, an important element of surveillance and risk assessment must also focus on these. As well, the judgement in setting macroprudential instruments will come from surveying, analysing and assessing – very carefully! – what is different this time. Policy advice and warnings may also come from tracking what is new and unregulated.

I would now like to turn to the governance of macroprudential policy.

Three important elements of governance (Figure 2) are the following:

- Legislating which committee or organisation will be the responsible macroprudential authority;
- The relationships (both legal and informal) between the macroprudential authority and other domestic regulators, and between the macroprudential authority and international bodies, including, importantly, international standard setters;
- The legitimacy of the macroprudential authority, which stems from its accountability, communication, staff quality and overall reputation – and is essential to the maintenance of any independence that it has been granted.

Figure 2



I believe that, because every financial crisis differs in some respects from previous crises, committees can be especially valuable in macroprudential governance.

Canada has not yet announced its macroprudential governance regime. It has had, however, a reasonably good experience with federal inter-agency committees over the past 15–20 years or so. Let me explain.

There is a Financial Institutions Supervisory Committee, chaired by the Superintendent of Financial Institutions (who is the supervisor of banks, insurance companies and pension funds). This committee also consists of the Governor of the Bank of Canada, the Deputy

Minister of Finance, the Chair of the Canada Deposit Insurance Corporation and the Commissioner of the Financial Consumer Agency of Canada. It meets at least quarterly to give advice to the Superintendent (who is not required to take it), and to coordinate policy actions when necessary. During some stages of the recent crisis, it was meeting almost daily. Because the senior members of the agencies are almost always present, they get to know each other well. This is very important in normal times, so it is easier to communicate when a crisis comes.

There is also a Senior Advisory Committee (on financial regulation), chaired by the Deputy Minister of Finance, which consists of the same members and gives advice to the Department of Finance on financial regulation and legislation.

Alan Blinder's work with John Morgan on committees and governance,[4] which focused on monetary policy committees, also suggests the value of committees: "Group decisions are on average better than individual decisions."[5]

Macroprudential policy touches deposit-taking institutions, insurance companies, broker-dealers, markets and market infrastructure. Given this diverse nature, cross-institutional committees should enhance legitimacy, as long as it is clear who is responsible and – most importantly – the committee keeps a true macroprudential orientation. It is also true that cross-institutional committees in large and medium-sized countries will, through their members, have appropriate international contacts at the G20, FSB, the BIS, the BCBS, and IOSCO.

I would now like to move to the third element of my presentation: cross-cutting policy issues, which I will illustrate by the area of housing and housing finance.

Housing finance and its regulation differ greatly across countries. As in the most recent crisis, many crises have been associated with bubbles in house prices and mortgage credit. There are at least three areas (Figure 3) where house prices and housing finance are important in thinking about the prevention of future financial crises:

- There are macroprudential tools, such as the use of maximum loan-to-value ratios;
- There is government involvement in the mortgage finance area, through insuring mortgages or securitised products, perhaps through a government-sponsored enterprise (GSE);
- There is the question of which inflation measure should be targeted or monitored by monetary policy and whether housing prices are included in that measure.

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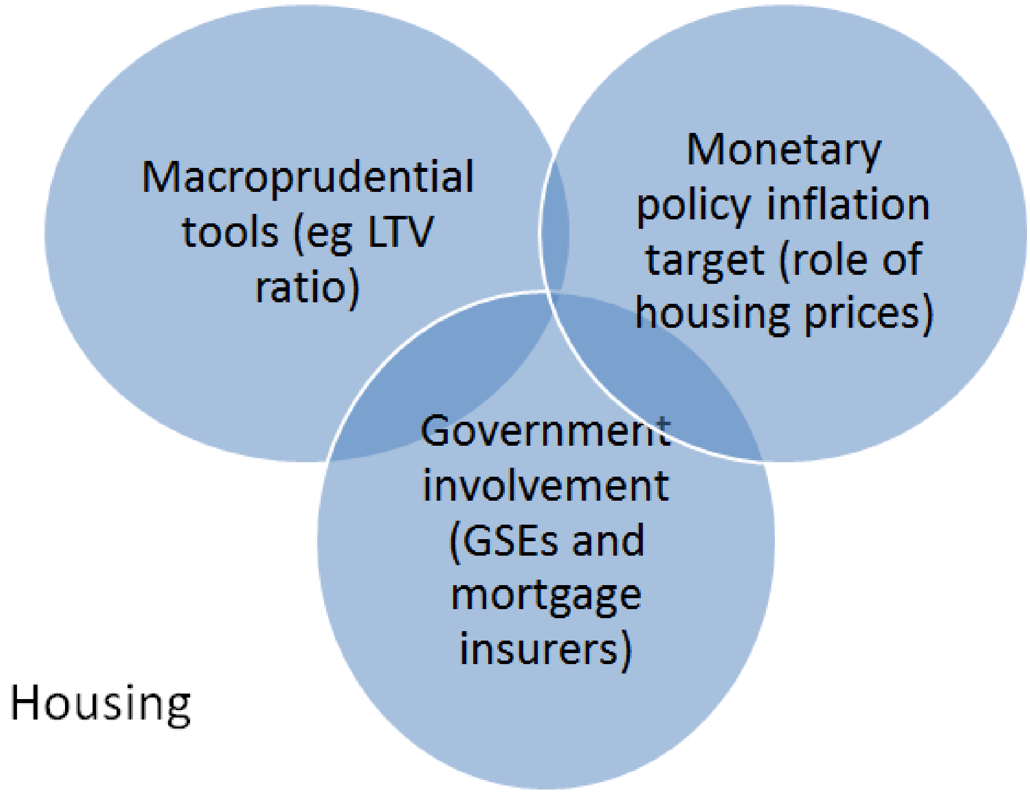
[4] A Blinder and J Morgan, "Are two heads better than one? Monetary policy by committee", *Journal of Money, Credit and Banking*, vol 37, no 5, 2005, pp 789–812.

[5] The authors noted that this result was true whether the groups made decisions based on majority rule or unanimity.

Figure 3



Given the "sameness" of crises, and given that the last crisis was closely related to mortgage finance that fed a housing price bubble in more than one country, it is somewhat disconcerting that most countries have not yet dealt with one or more of the following:

- The formal development of macroprudential tools associated with mortgage credit and housing prices (including countercyclical ones). More examination is necessary of the relative roles, for example, of loan-to-value ratios and debt-service-to-income ratios.
- The re-examination of the overall governance of GSEs, state-owned enterprises, and government insurers in the mortgage area, including how the terms and conditions that they set for insurance affect the behaviour of the mortgage and housing price cycle. These terms and conditions need to be examined at the same time as macroprudential tools in this area.[6]
- The re-examination of how housing prices should be incorporated in the overall inflation index targeted or monitored by the central bank. I would note that the Canadian CPI contains a few housing-related components that move closely with Statistics Canada's New House Price Index. This has been very helpful to Canadian monetary policy. Dropping housing from the targeted index in the United Kingdom in the move from the RPI to the harmonised index seems to have been distinctly unhelpful.

6 The governance of the process of adjusting requirements for obtaining mortgage insurance in Canada needs to be improved by clearly laying out the objectives.

Much is left to do from a policy point of view in the housing and housing finance area.

It is time to conclude.

Macroprudential policy should marry the best macro perspective with the use and significant tweaking of traditional microprudential policy instruments. The wedding gown at the marriage should have the traditional "something old, something new, something borrowed, something blue". The "something old" represents the focus on the things that are the same in financial cycles and financial crises. The "something new" represents the focus on innovations – new products, new products, new procedures. The "something borrowed" in many countries will be governance by committee, which should bring strength through diversity. At the moment, the "something blue" is that much more progress is needed on policy issues related to mortgage credit and housing prices. Those central banks that play an advisory role to their treasuries should not hesitate to speak up with good policy advice in this cross-cutting area. This will lead to a "blue sky" for the wedding day.