Annual MMF UK Monetary and Financial Conference

Objectives and Challenges of Macroprudential Policy:

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Friday 25 September 2015
Bloomberg, City Gate House, 39-45 Finsbury Square, London EC2A 1PQ

Overview

- The contours of the regulatory response to the recent financial crisis are now clear.
- UK at forefront of developments in macropru and much to admire in the current setup:

  A single, 'independent' macropru policymaker, located in the BoE with powers directly to influence bank lending and with a statutory role to help enhance financial stability in the UK.

- We try to step back and assess macropru in the UK.

Overview

We argue:

- The scope of macroprudential analysis is inherently very wide.
- Macroprudential authorities ought to have in their remit to assess the efficiency of the financial system and its constituent parts *and recommend action*.
- Why? It makes sense to focus on efficiency: the larger are the wedges of inefficiency, the more damaging negative shocks to and from the financial system are likely to be.
- Macroprudential regulators should be actively engaged in a wide range of policy areas such as corporate governance, competition and tax policy.
- We are NOT proposing the Bank/FPC becomes an omni-regulator! It should help society identify risks, propose solutions and understand trade-offs.

Overview: important externalities

We argue that time-varying capital requirements or lending restrictions centred on banks–for some the defining characteristic of macroprudential policy–are at best insufficient in addressing the impact of many externalities and wedges:

1. Balance sheet or fire-sale
2. Monetary transmission/aggregate demand externalities
3. Bailout externalities associated with the too-big-to-fail problem
4. Herding externalities

That is because these externalities, not all of them concentrated in the more regulated areas of the financial sector, interact with one another and with microprudential and other regulations blurring boundaries. Politics and tax policy are also *very* important.

Complications of macroprudential policy

Related to the politics point: Macroprudential policy faces three important challenges:

1. Macroprudential interventions typically have important distributional consequences.
2. It is difficult to determine the success or failure of macroprudential policy interventions in reasonable time.
3. It may be difficult to communicate the motivation for some macroprudential policy interventions.

So: Policy formation and institutional design and legitimacy are *joint* problems.

Key features of UK macroprudential oversight

In addition to the capital and liquidity requirements of Basel III:

1. The dominant role of Bank of England.
2. Establishment of a macroprudential authority (the FPC) with statutory responsibilities and powers (e.g., to advise on capital requirements and the ability to issue directions to the PRA and the FCA to amend microprudential regulations).
3. Bank ring-fencing.

Nothing has changed in terms of monetary and fiscal rules. We suggest developments are based on five premises.

Premises of UK macroprudential oversight

P1. Macropru, operating via micropru, should make sure financial frictions don't interfere with the normal operation of monetary policy.

P2. No need for an inflation-targeting monetary authority to take account of financial factors; financial frictions are largely invariant to the nominal regime.

P1. + P2. $\Rightarrow$ *systematic* component of monetary policy ought not to be part of macroprudential policy.

P3. No need for fiscal policymakers/politicians/tax policy to get involved.

P4. Some banks, in part due to "hidden" subsidies, had become too big to fail (TBTF). Ending universal banking, increased capital requirements and overhauled recovery and resolution are the key to ending TBTF.

P5. Macroprudential regulation should be applied to entities (mostly banks), rather than activities.

Monetary policy

P1. Macropru to ensure financial frictions do not interfere with monetary policy.

This premise has a long pedigree.
Friedman and Schwartz (1963) and Friedman (1985) argued that the FDIC was

> *"...we regard federal deposit insurance as so important a change in our banking structure and as contributing so greatly to monetary stability – in practice far more than the establishment of the Federal Reserve System."*

In some ways, Farhi and Werning (2013) is a version of the Friedman-Scwhartz.

So: an important role of macroprudential policy *is* to maintain the effectiveness of monetary policy.

But

if financial instability is arising through exploitation of deposit subsidies, herding, irrational exuberance, rational bubbles, poor contract design, tax distortions, balance sheet amplification or collateral fire sales, then even optimal monetary policy with 'perfect' transmission will not restore constrained efficient allocation of investment or employment outcomes.

$\Rightarrow$The scope of macroprudential policy could justifiably include wider concerns for financial sector efficiency over and above maintenance of the monetary transmission channel.

Tax policy

P3. tax policy + politicians to have limited macroprudential role.

In practise, they probably have an extensive role.

- Chancellor sets tone.
- Chancellor sets priorities: reform of the banking system “is close to finalisation”

  “....I would like the Committee to consider how, subject to its primary objective to protect and enhance the stability of the UK’s financial system, its actions might affect competition and innovation, and their impact on the international competitiveness of the UK financial system.”

- Tax system has many points of contact with the financial system and financial stability.

Tax policy

P3. tax policy + politicians to have limited macroprudential role.

- Choice of debt versus equity;
- Bank profit surcharge tax (in place of bank levy);
- Restrictions of loan-to-value (LTV) and/or debt-to-income (DTI) alongside UK Government's Help to Buy equity loan programme, and the Help to Buy individual savings account programme.
- Similar (deliberate or not) coordination took place in New Zealand.

It *may* make sense to coordinate in this way.
But

- It may just suppress legitimacy concerns;
- Macropru measures may be intended to be temporary, what of the subsidies?
- moral hazard problems;
- Subsidy-based interventions complex in incomplete markets settings;
- Questions the regulator's independence.

Too big to fail

A central problem of the recent financial crisis.
But now (or soonish)

- there is more and better capital and liquidity
- GSIBs have been identified and will be supervised more stringently
- a roadmap, agreed across countries, has been approved on how to resolve these banks in case of trouble.

Job done?

Too big to fail

But:

- Banking sector more concentrated since the financial crisis, partly as a result of bank bailouts.
- Governments and central banks bailed out more than just banks and
- guaranteed liabilities much wider than those covered by deposit protection schemes.
- As a result of changes in prudential rules many of the risks that were ‘contained’ within the regulated banking sector may migrate to less regulated areas of the financial system.

Too big to fail

The new resolution regime may simply boil down to a state-contingent commitment finally to break up banks in likely turbulent economic times during febrile financial market conditions.

- But how fundamentally different is that to the situation before the recent crisis?
- Have much have these reforms changed the incentives facing shareholders and debt-holders in any bank?

If banks need to be broken up in difficult times then one might wish to argue they ought to be broken up now.
So, just break them up, then?

An effective and legitimate macroprudential authority

- Ideally, the macroprudential regulator would be an omnipotent, omniscient and and benevolent!
- Environment and politics necessarily (and rightly) get in the way.
- The extent to which the macroprudential regulator can act quickly and unilaterally with their instruments (dictatorship) is sustained by the regulator's legitimacy, which is protected by limiting the powers of the regulator (removing their omnipotence) *and assigning the regulator with clear intermediate policy targets.*

So: the political issue of legitimacy is inseparable from the technical problem of optimal policy.

But no strong consensus over

- the key policy problems
- the likelihood of crises or volatility of leverage and credit spreads in an efficiently working economy.
- a measure of riskiness of the system as a whole.

So, how do you design intermediate targets?

An effective and legitimate macroprudential authority

- Illegitimacy concerns could be amplified if regulators are seen to have close links to the financial sector and at the same time propose regulations or tax changes that are perceived to likely worsen the distribution of wealth and/or income.
- It is hard to find a parallel to macroprudential policy in terms of the powers that are delegated, the difficulties in communicating how policies are likely to meet objectives, and the difficulties in determining even ex post whether or not the regulator has achieved their goals of ensuring financial stability.

Institutional recommendations

Our aim is to think longer term as to what might work, balancing transparency and accountability with optimal scope and nature of macropru. Clearly not an easy balance.

1. In addition to its responsibility to enhance financial stability, the FPC should be made responsible for assessing the efficiency of the financial sector in the UK.
2. That financial efficiency assessment should generate policy recommendations for other areas of public policy. For example, the FPC should be required to comment on any area of policy (public or private) which may damage efficiency or exacerbate financial stability (e.g., tax policies that increase leverage, housing, planning or land use policies, the incentive structure of private sector pay, distortions in accessing bank or equity finance for SMEs, etc.).
3. Policymakers should design a set of intermediate targets against which the FPC can be judged.

Policy recommendations

10. We have not, in all likelihood, ended TBTF. The FPC should review the design of possible future bailouts with the aim of designing penalties which are time consistent and encourage key executives and groups (such as shareholders) to internalize appropriately the moral hazard risks.
12. The FPC should assess and advise Government appropriately on the extent to which leverage is encouraged through the differential tax treatment of debt and equity and the bank levy.
13. Minimise the use of time-varying restrictions.
14. Important to consider whether specific regulations should be imposed at the level of entities (for example banks) or activities (for example mortgage lending).

A question

Complete this sentence:

> *"The UK largely avoided the worst of the Global Financial Crisis of 2035, due in large part to _ _ _ _ _ _ _ _ _ _."*

Governance concerns

Structure (and size) of banker compensation packages a concern.
Banking and reputation
Disreputable actions span retail and wholesale businesses of UK banks, including (but not limited to) the mis-selling of

- payment protection insurance
- interest rate derivative contracts to retail and commercial customers
- manipulation of LIBOR benchmark interest rates and foreign exchange rates.

Governance concerns

Disagreement over the design of compensation contracts is likely to be a reflection of poor bank regulation
$\Rightarrow$excessive risk taking so that
any regulations targeting banker compensation structures are likely to be subverted. Bonuses will be replaced by "allowances".
Picture could be more complicated still:

- Questions over the effective discount rate of bank shareholders;
- Shareholder governance structures;

Systemic risk insurance

- Debt contracts ⇒ useful for managing individual risks...but bad at sharing systemic risk–why?
- Mian and Sufi (2015) and Shiller (2008) have argued that greater risk sharing should be built into mortgage contracts through built in risk sharing and house price derivative contracts respectively.
- Carlstrom, Fuerst, and Paustian (2014), Krishnamurthy (2003) and Nikolov (2014): "What financial accelerator?"
- Cochrane (2014) and Goodhart (1988, Ch. 7): bank deposits could be replaced by equity-like contracts while still providing useful payment services.

So: If certain systemic risks could be reflected in private contracts, or if monetary policy could mimic the effects of such trade, that may well seem desirable.

Systemic risk insurance

Systemic risk insurance contracts are likely to be complicated.

Allen and Gale, 2001, Ch. 14: more likely these sophisticated contracts could be provided by financial intermediaries (likely banks), who can design contracts tailor made for households and firms, rather than decentralised markets.

BUT

Recent experience not good:

Banks in UK

- mislead customers when selling payment protection insurance and interest rate swap products.
- manipulated benchmark interest rates and foreign exchange rates, which are used to determine payments in financial products designed to hedge against macroeconomic risks.

In the near-term such 'markets' may not work effectively.

Mian and Sufi (2015) and Shiller (2008) have argued that the status quo is inefficient, and that mortgage contracts should include a component that fluctuates in response to the general level of house prices, to provide some insurance against these fluctuations. So, there seems to be a *demand* for insurance.

What about supply? During the 2008 financial crisis, which agents were under-exposed to house prices?

Maybe banks and firms had *too much* exposure to real estate prices, in effect selling too much insurance against downturns in property values through derivative securities contingent on mortgage repayments and property values.

private buy-to-let market also provides a measure of risk-sharing too.

Systemic risk insurance

aggregate demand externalities

According to Mian and Sufi (2015), systemic risk insurance through risk sharing mortgage contracts would have resulted in transfers to agents with high marginal propensities to consume at the onset of the crisis, dampening the decrease in aggregate demand.

But

In general, competitive systemic risk insurance does not internalize aggregate demand externalities.