Operationalising macroprudential tools

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on "Macroprudential policy: what instruments can be effective?"
Bruegel

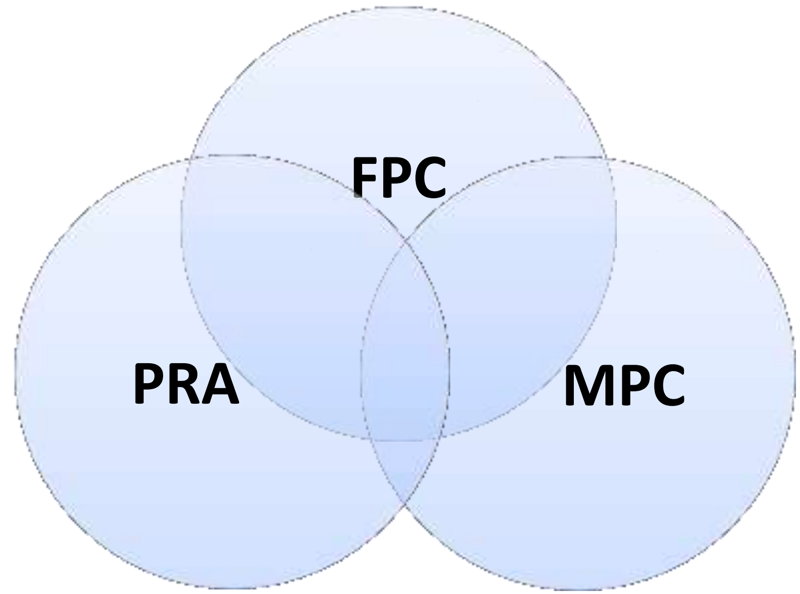
*The views expressed in this presentation are those of the presenters and not necessarily those of the Bank of England. Not for further distribution.

Outline

- Introduction
- Which tools?
- Which indicators?
- What impact on financial stability and growth?

Role of the Financial Policy Committee (FPC)

- FPC set up to take a top-down macroprudential view
- Mandate to "protect and enhance the resilience of the UK financial system"
  - Subject to that, support growth and employment



- Includes members of the Bank's executive, microprudential heads, and externals:
  - Non-voting HM Treasury representative

FPC’s powers

Micropudential regulators

General Recommendations	Comply or Explain Recommendations	Directions
• eg to HM Treasury over regulatory perimeter	• Better suited for tackling structural, cross-sectional risks	• Binding instructions

- Directions carry greater statutory force – so which specific tools?

Which macroprudential tools?

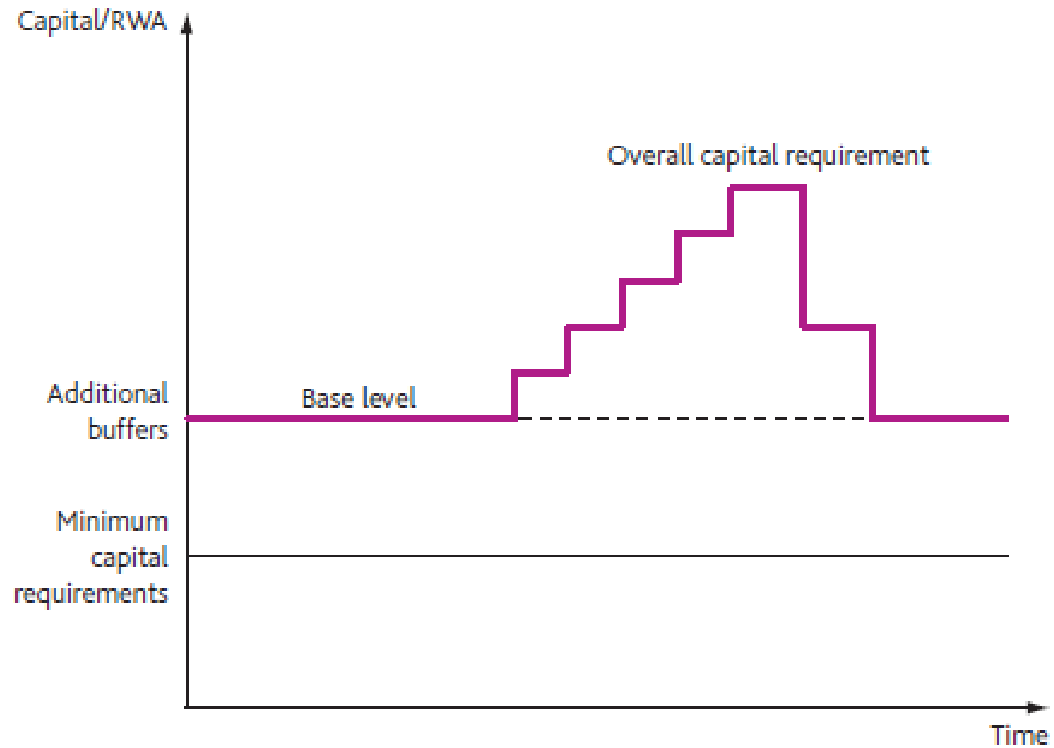
- FPC will have immediate powers over
  - Countercyclical capital buffer (CCB)
  - Sectoral capital requirements (SCRs)

Policy Statement:
The FPCs' Powers to Supplement Capital Requirements (2013)

- Future candidates?
  - Leverage ratio (in 2018, subject to review in 2017)
  - Liquidity tool
  - Margining requirements
  - LTV / LTI restrictions

Countercyclical capital buffer (CCB)

- Part of Basel III framework
- Additional <u>temporary</u> capital buffer applied at an aggregate level
  - FPC sets CCB rate for UK lending
  - Other countries set national CCB rate for overseas lending
  - Mandatory reciprocity in EU up to 2.5% RWAs



(a) 'Additional buffers' refers to the capital conservation buffer, systemic risk buffers and any forward-looking guidance on capital levels by the microprudential regulators.

Sectoral capital requirements (SCRs)

- FPC sets temporary additional capital requirements on
  - Residential mortgages
  - Commercial property exposures
  - Exposures to other financial sector entities

- More targeted/flexible than CCB
  - Could target risky sub-sectors
    - High-LTV mortgages
    - Financial sector: institutions (eg exposures to SPVs) or instruments (eg repos)
  - Could apply to stock of existing loans or just new lending

Core indicators to guide decision making

- Serve two purposes
  - Internally: Starting point for analysis, consistency
  - Externally: Transparency, accountability, predictability

- Not meant as a substitute for judgement

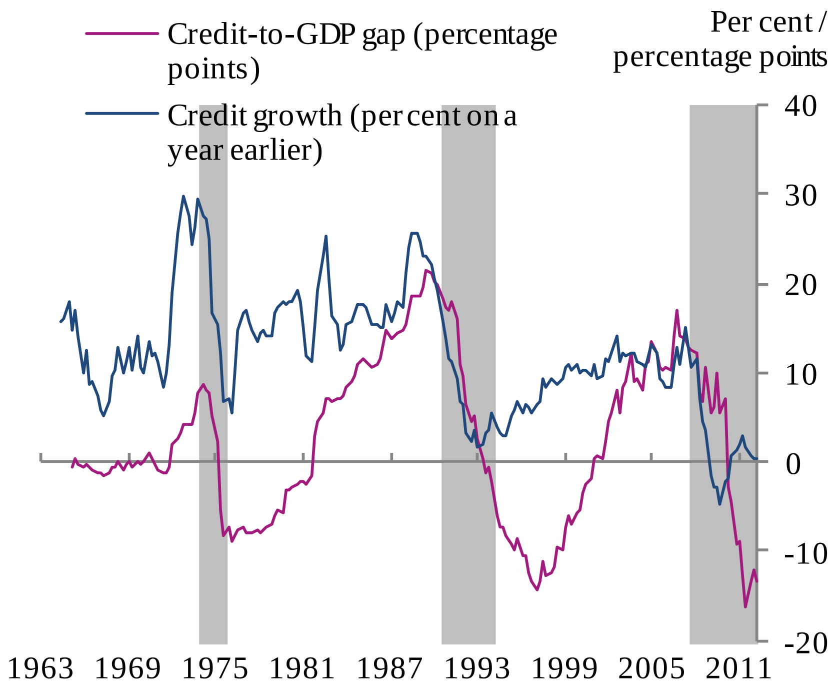
- Which indicators?
  - Complements to the credit-GDP gap
  - Simple, high-level, understandable
  - Categorisation: bank balance sheet stretch, borrower stretch, terms and conditions in financial markets

Table C Core indicator set for the countercyclical capital buffer[1]

Indicator	Average, 1987–2006[2]	Average 2006[3]	Maximum since 1987[2]	Minimum since 1987[2]	Latest value
Bank balance sheet stretch[4]					
1 Core Tier 1 capital ratio[5]	6.6%	6.3%	10.8%	6.1%	10.8% (2012 H1)
2 Leverage ratio[6]					
Simple	4.7%	4.1%	5.4%	2.9%	5.1% (2011)
Basel III	n.a.	n.a.	n.a.	n.a.	4.2% (Oct. 2012)
7 Bank debt measures					
CDS premia[11]	12 bps	8 bps	298 bps	6 bps	168 bps (Nov. 2012)
Subordinated spreads[12]	29 bps	10 bps	967 bps	4 bps	354 bps (Nov. 2012)
8 Bank equity measures					
Price to book ratio[13]	2.14	1.97	2.83	0.52	0.76 (Nov. 2012)
Market-based leverage ratio[14]	9.6%	7.8%	14.8%	1.9%	3.9% (Nov. 2012)
Non-bank balance sheet stretch					
9 Credit-to-GDP[15]					
Ratio	131.8%	179.1%	198.4%	93.8%	183.7% (2012 Q2)
Gap	4.2%	13.0%	21.4%	-16.3%	-13.3% (2012 Q2)
10 Private non-financial sector credit growth[16]	10.8%	10.1%	25.6%	-4.7%	0.4% (2012 Q2)
Conditions and terms in markets					
14 Long-term real interest rate[20]	3.09%	1.25%	5.14%	0.02%	0.04% (Nov. 2012)
15 VIX[21]	19.1	12.8	65.4	10.6	16.7 (Nov. 2012)
16 Global spreads[22]					
Corporate bond spreads[23]	115 bps	87 bps	486 bps	52 bps	139 bps (Nov. 2012)
Collateralised and securitised debt spreads[24]	50 bps	46 bps	257 bps	15 bps	63 bps (Nov. 2012)
17 Spreads on new UK lending					
Mortgage lending[25]	81 bps	56 bps	368 bps	42 bps	351 bps (Oct. 2012)
Corporate lending[26]	103 bps	98 bps	389 bps	93 bps	332 bps (2012 Q3)

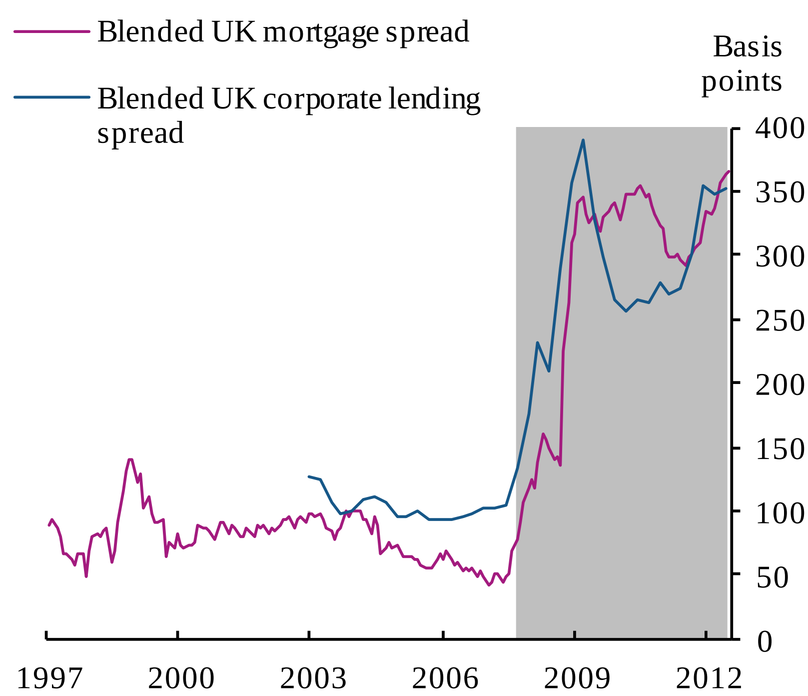
Indicators in the current conjuncture (1)

Weak credit...



Sources: Bank of England, ONS and Bank calculations.

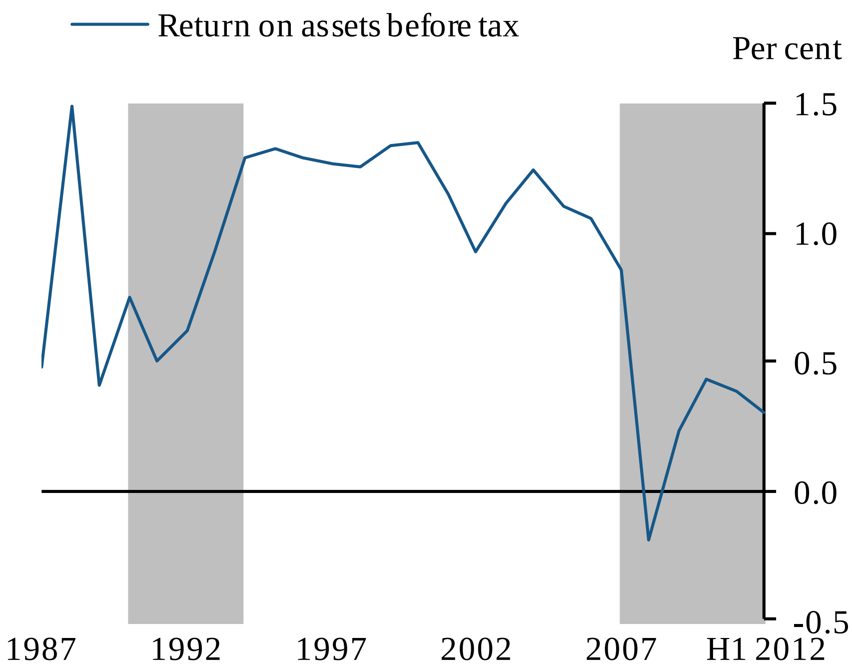
...and elevated spreads on new lending



Source: Bank of England, Council of Mortgage Lenders (CML), British Bankers' Association, Bank of America Merrill Lynch, de Montfort University, Bloomberg and Bank calculations.

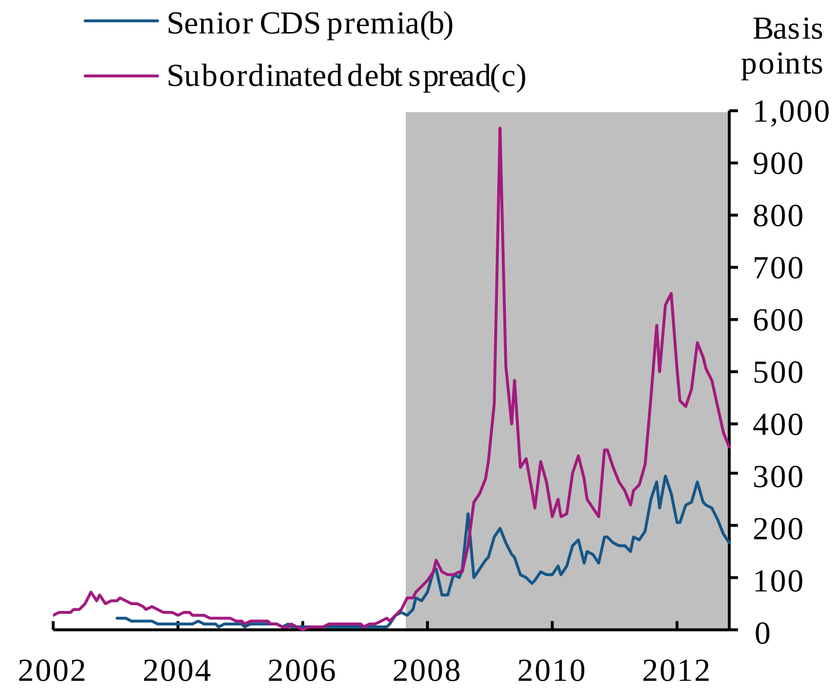
Indicators in the current conjuncture (2)

but weak profitability...



Sources: Published accounts and Bank calculations.

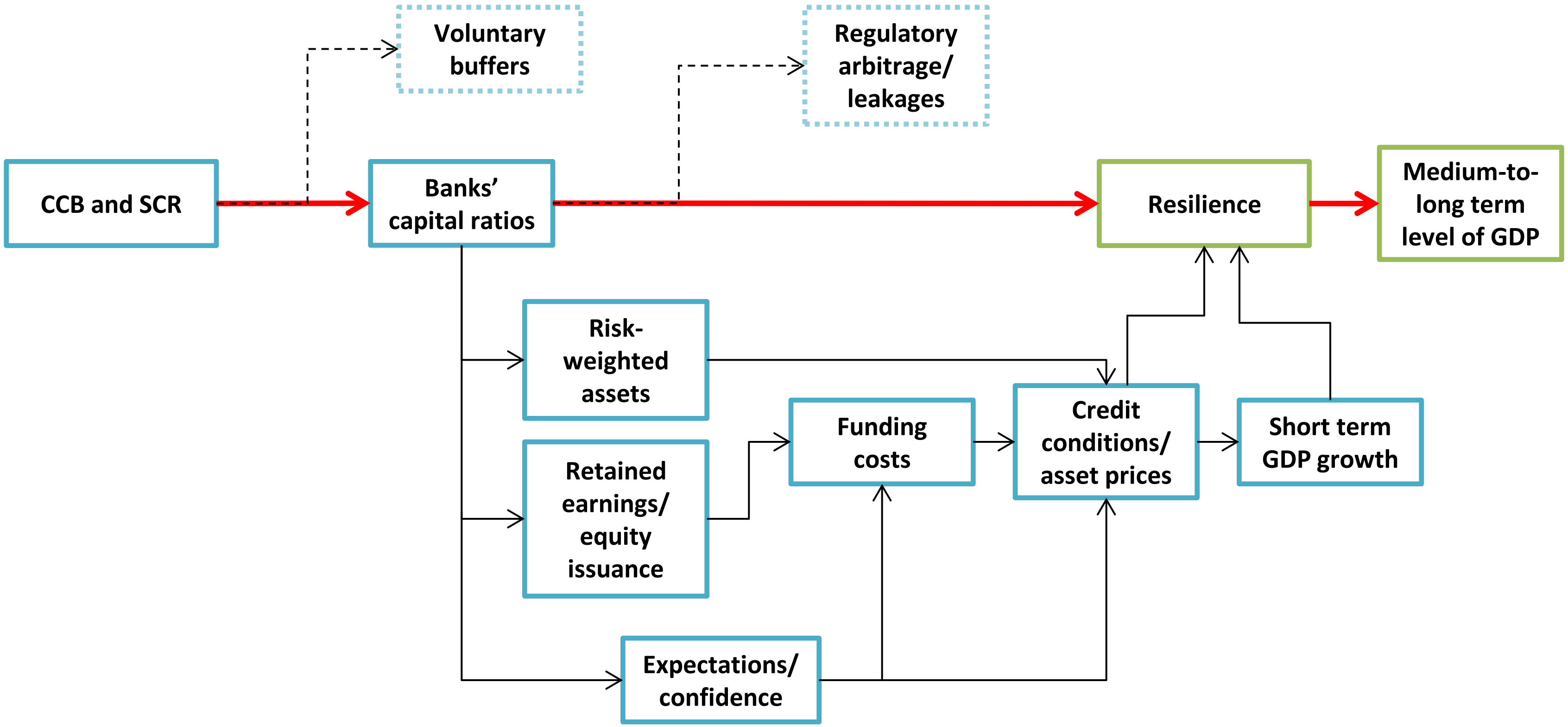
...and low investor confidence



Sources: Markit Group Limited, UBS Delta, Thomson Reuters Datastream, published accounts and Bank calculations.

at a time of heightened sovereign and banking sector risks in some euro-area countries, and with capital starting from a weak position

Map of the transmission mechanism



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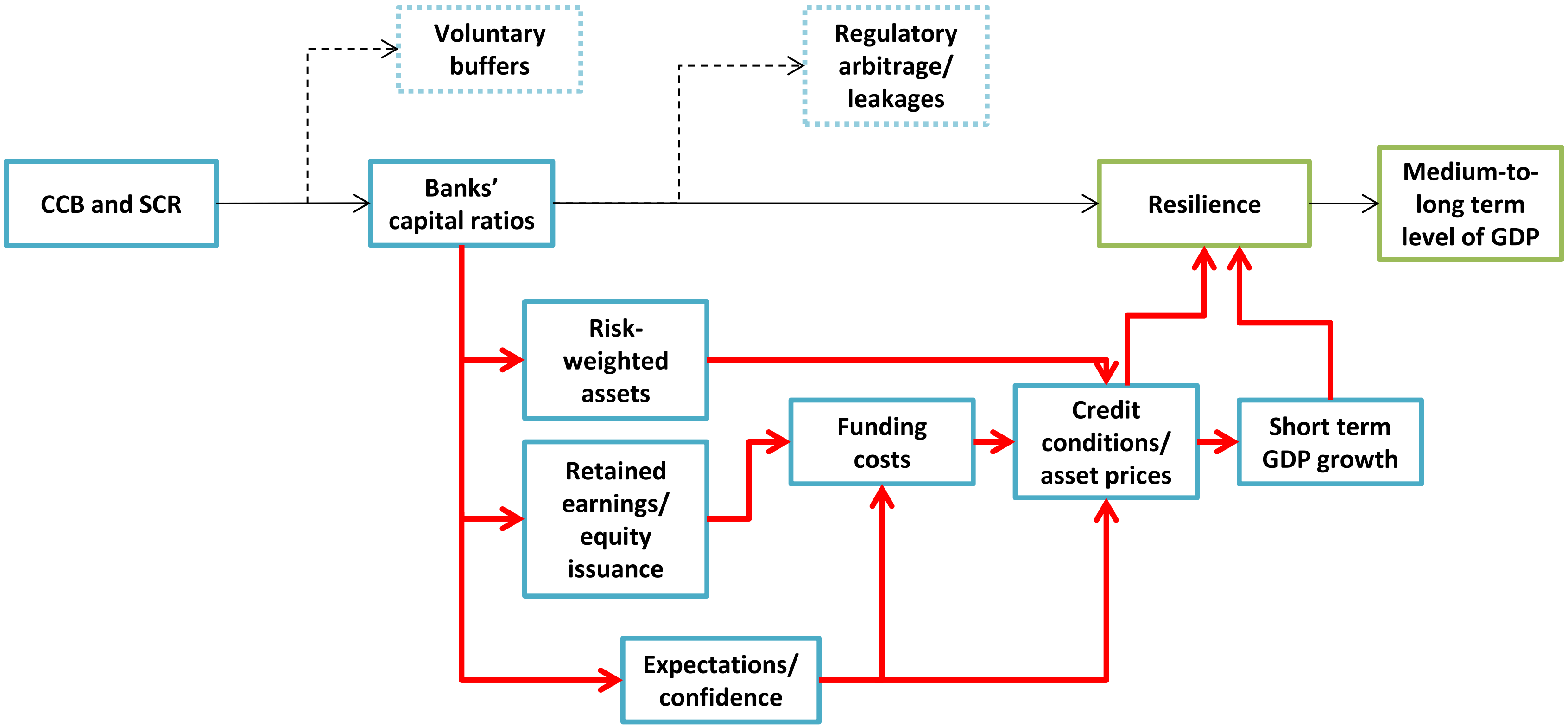

Cross-border spillovers

- Large potential positive cross-border spillovers from enhancing resilience

- Negative spillovers also possible
  - host credit conditions affected if acting at group level
  - evidence points to large leakages if policy is uncoordinated: eg Aiyar et al (2012) find that 1/3 of the impact of higher capital requirements offset by foreign branches

- Need to balance coordination with avoiding inaction bias
  - Nature of optimal coordination probably varies over cycle

Policy process timeline

3-6 months

X months

12 months

?

Risk assessment process → FPC decisions → Coordination process → Implementation → Impact

Lags in data availability

Conflicting indicators, consensual decision-making, lobbying, decisions may be unpopular, cost-benefit analyses

CRDIV/CRR

CCB: Firms have 12 months
SCR: as soon as is reasonably practicable, requirement to consult

Economic/ behavioural lags

Open issues

- How to balance “resilience” v “credit supply”?

- How ‘activist’ should policy be?

- Coordination in relation to:
  - microprudential regime
  - monetary policy

- Making mistakes without losing credibility