MACROPRUDENTIAL POLICY: PAPERS NEEDED

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Lessons from the financial crisis

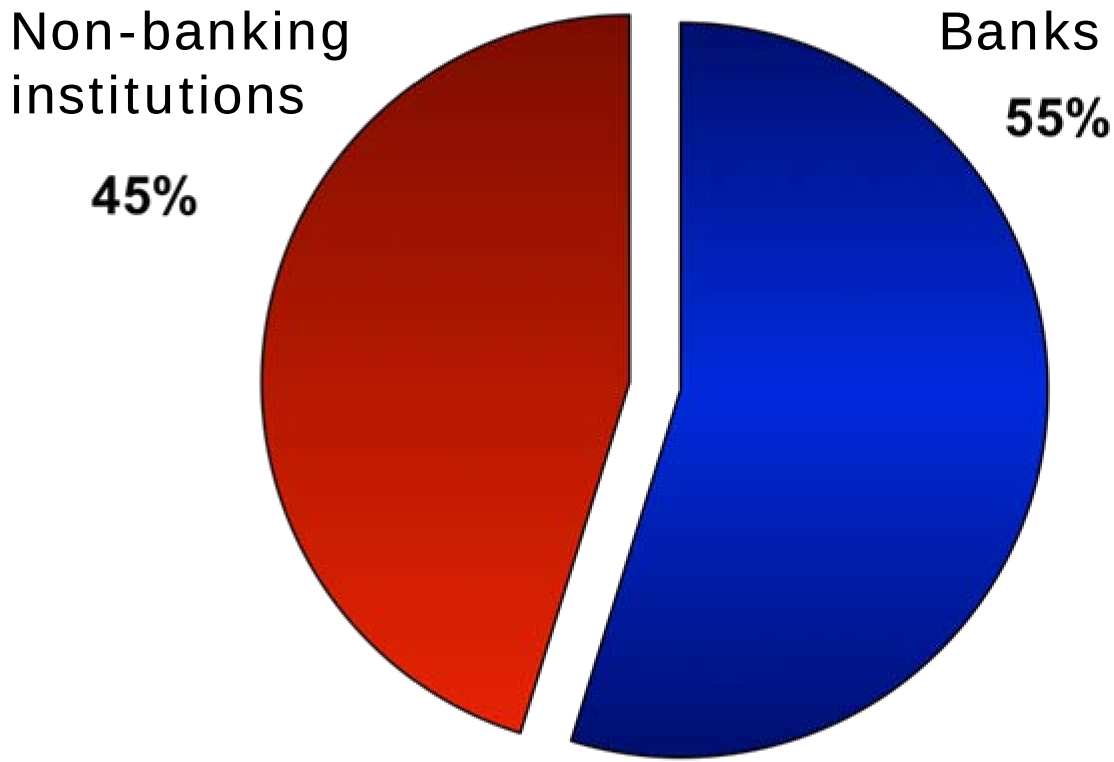
1. Risk in a financial system is more than an aggregation of risks in individual institutions

2. We need models of financial frictions where the frictions arise from problems with credit supply (see figure)

Corollary: macroprudential policy (MaP) is needed

Conventional wisdom: MaP would have prevented the financial crisis

Regulatory perimeter: it´s the credit, ……



Questioning the current convention

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- MaP not necessary (not sufficient?) to prevent the financial crisis: Chile

  NO Financial Stability Board,

  NO Basel II / III,

  NO consolidated supervision of financial conglomerates,

  NO stress testing, ……..

  ……. <u>NO subprime crisis</u>

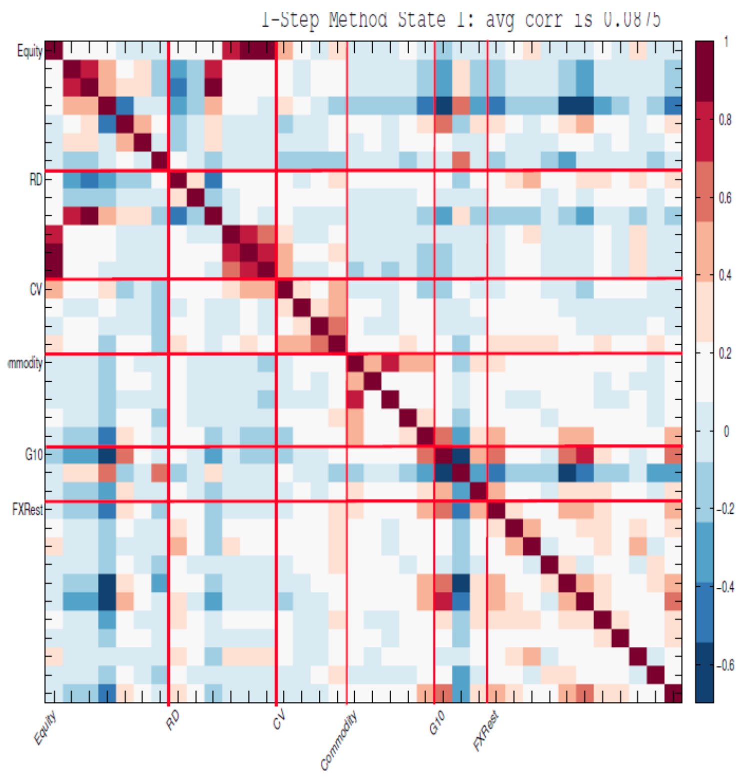
The redemption of microprudential policy

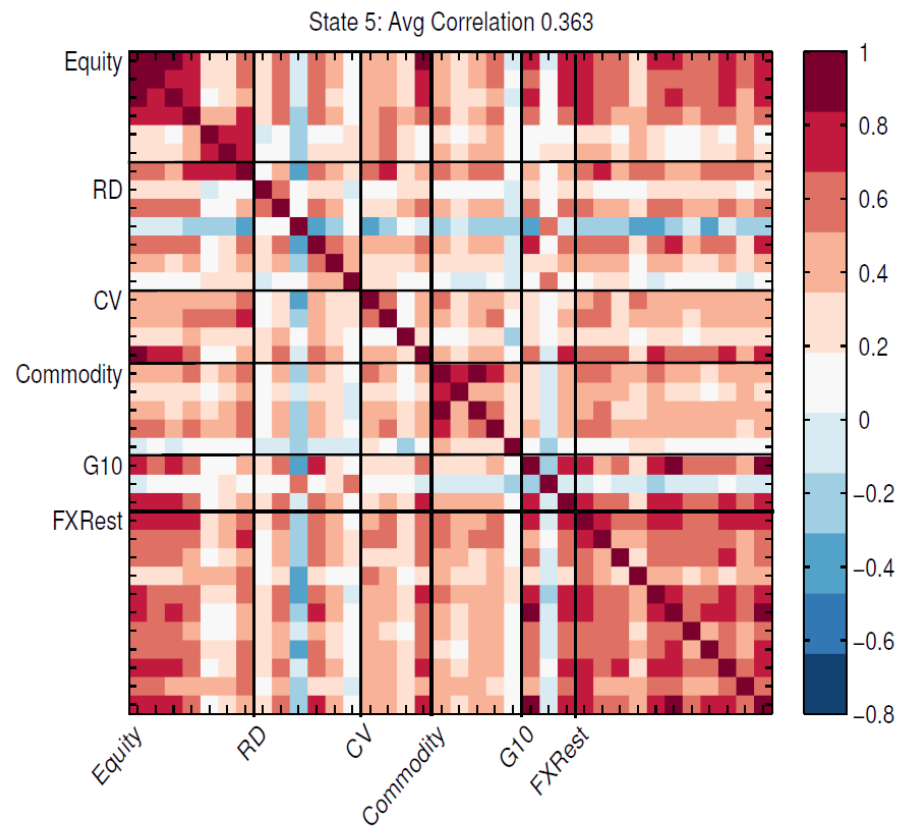
- The purpose of MaP is to reduce systemic risk, dealing with market failures (endogenous risk arising from the collective behavior of institutions that amplified individual risk). But the Great Recession was mainly the result of a poor assessment of individual risk.

- A well known microprudential policy (MiP) issue: lightly regulated non-banking institutions combining highly leverage and short maturity funding → inadequate risk management.

The excuse by the market

- “When the music is playing, you have to get up and dance.” Citigroup’s former chief executive Chuck Prince (2007).





But not always, not everybody

- “All financial crisis are brought about by the same circumstances: easy money, slack regulation, and blue skies thinking.” (Christine Lagarde, 2011)
- The last 40 years have been un unprecedented era of high and procyclical leveraging of banks *ex ante*, and extreme banking fragility and loss *ex post* (110 severe banking crises, with an average negative net worth of 16% of GDP; for the pre-WW I era, 4 crisis, average severity of 6%).
- Citibank, Bear Stearns, Lehman, Merrill, UBS, AIG collapsed; BUT JP Morgan Chase, Goldman, Morgan Stanley, Deutsche, credit Suisse, Met Life remained quite healthy.
- Corporate governance: banks with a high ratio of the compensation paid to the CRO relative to the CEO suffered less risk *ex ante* and less loss *ex post*.

Microprudential policy needed for financial stability

- In Chile, ...

  Market determined interest rates that signal the right allocation of funding and level of risk taking.

  Tight regulations: forbidding securitization, options, derivatives; and strongly limiting funding from related parties. LPB?

  And strong supervision, focusing on credit risk and provisions, and yearly *in situ* evaluations: institutional commitment to risk management.

The redemption of macroprudential policy

- But there is a trade-off....
- ... a highly developed and innovative financial system is indispensable for economic growth, but there is also an inherent risk of exaggerations. Regulatory efforts have to constrain such exaggerations, but without stifling innovation and thereby hampering economic growth.
- MaP alongside MiP, by providing the tools to focus on the stability of the financial system as a whole (and of each individual institution) permit that balance.
- **Easier said than done**: for MaP to work, several questions remain to be answered.

Papers needed: the general questions

I. How should the objective of MaP be framed?
II. Is MaP a genuinely separate policy area?
III. How can conflicts of objectives with other policy areas be handled?
IV. How much of any macroprudential regime should be set out in statute?
V. How should the identifications of vulnerabilities be approached?
VI. What data are needed?
VII. What MaP instruments are available and will they work?
VIII. How should the institutional framework be designed?
IX. How should the transition from peacetime to crisis be handled?
X. How can domestic/international arrangements best be fitted together?

Papers needed: data

a) How to measure systemic risk? Leading indicators of systemic financial distress? Pros and cons of different quantitative aggregates, such as types of credit? Is there useful additional information in the liability side of financial sector intermediaries, such as the ratio of wholesale to retail funding? In risk premia? Is it possible to develop coherent measures of aggregate leverage? How best can we incorporate the international and global dimensions? And we must collect data on bank's trading and securitization exposures and liquidity risks.

b) The linkages among financial firms, especially the largest firms, to identify potential sources of spillovers; better measures of counterparty credit risk and interconnectedness among systemically critical firms;

c) Indicators of concentration risk in real time; concentrations of exposures by leveraged financial intermediaries to large aggregate risks, to quantify how large a macro shock would be required to seriously compromise the capital buffer of the financial system as a whole (stress-testing).

Papers needed: models

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a) We need models in which liquidity -- including monetary and credit aggregates -- the measurement and pricing of risk, and distortions in capital accumulation and balance sheets play fundamental roles. We need models that generate booms and bust cycles endogenously. What cross-sectional and intertemporal coordination failures are more critical? We need models in which, as the empirical evidence strongly suggests, financial crises have very long-lasting effects on the level of output. What can explain these effects? And what implications do they have for macroeconomic policies, beyond MaP?

b) Developing better models can help us understand the efficacy of different macroprudential instruments. This will require models to be rich enough to incorporate tools in a meaningful way. Another approach is to investigate their effectiveness based on cross-country empirical work, supplemented by case studies. So far, data limitations have held back this type of research.

Papers needed: tools

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a) Optimal instruments and targets under the three categories of risks: balance sheets (leverage ratio, countercyclical capital buffer, sectoral capital requirements, liquidity requirement), the terms and conditions of loans and other financial transactions (caps on LTV ratios and minimum margins), and market structures (requirements for disclosure to reduce uncertainty about the market exposure of individual banks, and the use of central counterparties to clear trades).

b) Aggregate insurance provided by the government, for instance, through a sovereign bond (for the private sector, it would require too much capital). For a premium, the government would explicitly assume most of the tail aggregate risk, while the private sector would provide the capital necessary to deal with micro risk and small aggregate shocks. (Caballero, 2010)

Papers needed: regulatory perimeter

a) While higher capital and liquidity requirements on banks will insulate the banks themselves, they may also drive a larger share of intermediation into the shadow-banking domain. For example, corporate and consumer loans could be securitized, and end up being held by hedge funds (highly-leveraged investors not subject to capital regulation).

b) It is also obvious that MaP will work much better if they are applied to all lenders and to all countries simultaneously. If no consensus, which elements of MaP can be implemented at the national level?

Papers needed: rules vs. discretion

a) Keep it simple, to make everybody accountable.

b) A challenge of macroprudential regulation is strong resistance to countercyclical actions during booms. Having a rule-based approach will largely obviate this problem.

c) If MaP is going to work, it will have to be coordinated across countries to synchronize the timing of regulatory changes. That need for synchronization creates political challenges that further strengthen the political economy argument in favor of simple macroprudential rules based on observable criteria.

d) The monetary policy literature shows that simple rules are desirable when policymakers face uncertainty about the structure of the economy and the source of economic shocks. This conclusion may apply to MaP and supervision as well.

e) In financial regulation, less may be more

Papers needed: institutional framework 1

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a) To improve the infrastructure for the clearing and settlement of derivatives. For example, by improving the documentation and transparency of credit default swaps, increasing the standardization of contracts and requiring standardized derivatives to be cleared through well regulated central of counterparties.

b) In favor of combining prudential supervision with central banking: (1) information-related synergies between supervision and core central banking functions; (2) focus on systemic risk; and (3) independence and technical expertise.

c) In favor of attributing supervisory powers to a single agency outside the central bank: (1) the potential for conflicts of interest between supervision and monetary policy, and moral hazard; (2) the tendency towards conglomeration; and (3) the need to avoid an excessive concentration of power in the central bank.

Papers needed: institutional framework 2

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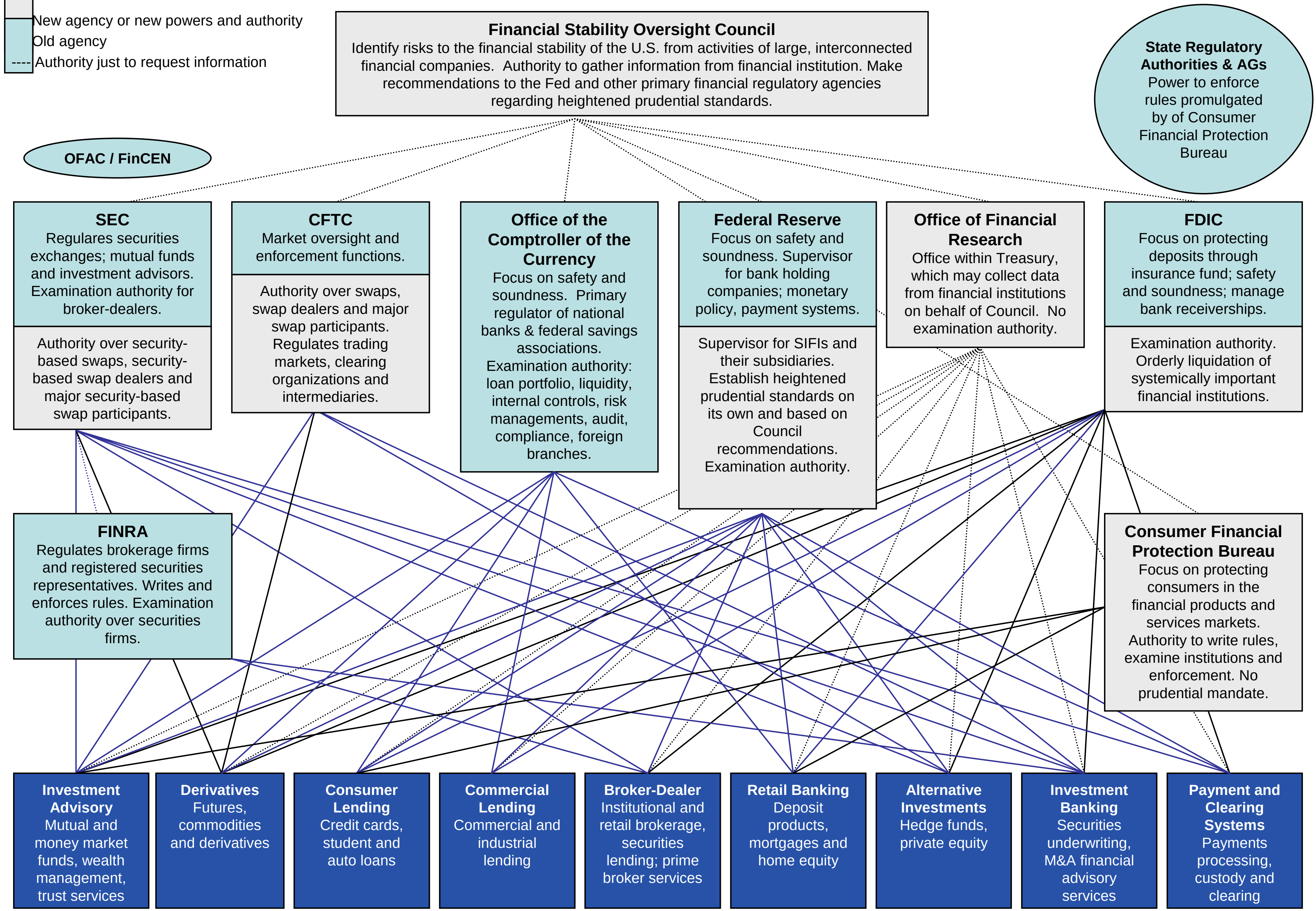
d) Central banks in charge during peacetimes. But in a crisis the finance ministry should be in overall charge, partly because there is likely to be a key question about whether and if so how fiscal resources should be used, but also because the response to any significant financial disruption could involve difficult political judgments.

e) Keep it simple, to avoid regulatory arbitraje.



New agency or new powers and authority
Old agency
---- Authority just to request information
Financial Stability Oversight Council
Identify risks to the financial stability of the U.S. from activities of large, interconnected financial companies. Authority to gather information from financial institution. Make recommendations to the Fed and other primary financial regulatory agencies regarding heightened prudential standards.
State Regulatory Authorities & AGs
Power to enforce rules promulgated by of Consumer Financial Protection Bureau
OFAC / FinCEN
SEC
Regulares securities exchanges; mutual funds and investment advisors. Examination authority for broker-dealers.
Authority over security-based swaps, security-based swap dealers and major security-based swap participants.
CFTC
Market oversight and enforcement functions.
Authority over swaps, swap dealers and major swap participants. Regulates trading markets, clearing organizations and intermediaries.
Office of the Comptroller of the Currency
Focus on safety and soundness. Primary regulator of national banks & federal savings associations. Examination authority: loan portfolio, liquidity, internal controls, risk managements, audit, compliance, foreign branches.
Federal Reserve
Focus on safety and soundness. Supervisor for bank holding companies; monetary policy, payment systems.
Supervisor for SIFIs and their subsidiaries. Establish heightened prudential standards on its own and based on Council recommendations. Examination authority.
Office of Financial Research
Office within Treasury, which may collect data from financial institutions on behalf of Council. No examination authority.
FDIC
Focus on protecting deposits through insurance fund; safety and soundness; manage bank receiverships.
Examination authority. Orderly liquidation of systemically important financial institutions.
FINRA
Regulates brokerage firms and registered securities representatives. Writes and enforces rules. Examination authority over securities firms.
Consumer Financial Protection Bureau
Focus on protecting consumers in the financial products and services markets. Authority to write rules, examine institutions and enforcement. No prudential mandate.
Investment Advisory
Mutual and money market funds, wealth management, trust services
Derivatives
Futures, commodities and derivatives
Consumer Lending
Credit cards, student and auto loans
Commercial Lending
Commercial and industrial lending
Broker-Dealer
Institutional and retail brokerage, securities lending; prime broker services
Retail Banking
Deposit products, mortgages and home equity
Alternative Investments
Hedge funds, private equity
Investment Banking
Securities underwriting, M&A financial advisory services
Payment and Clearing Systems
Payments processing, custody and clearing