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Macroprudential policy

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ITAM Summer Camp

24th August 2012

1 Basic concepts

Section 1

Basic concepts

Three different but closely related concepts

Systemic risk

- Risk of disruption to financial services caused by an impairment of all or parts of the financial system.
- Not only SIFIs

Macroprudential Policy

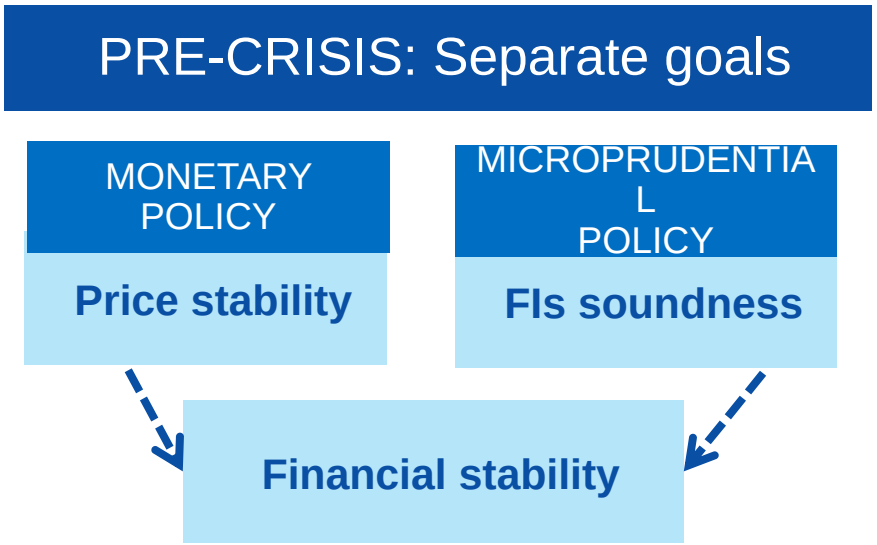
- Introduces systemic dimension in prudential policies
- Key complement to microprudential

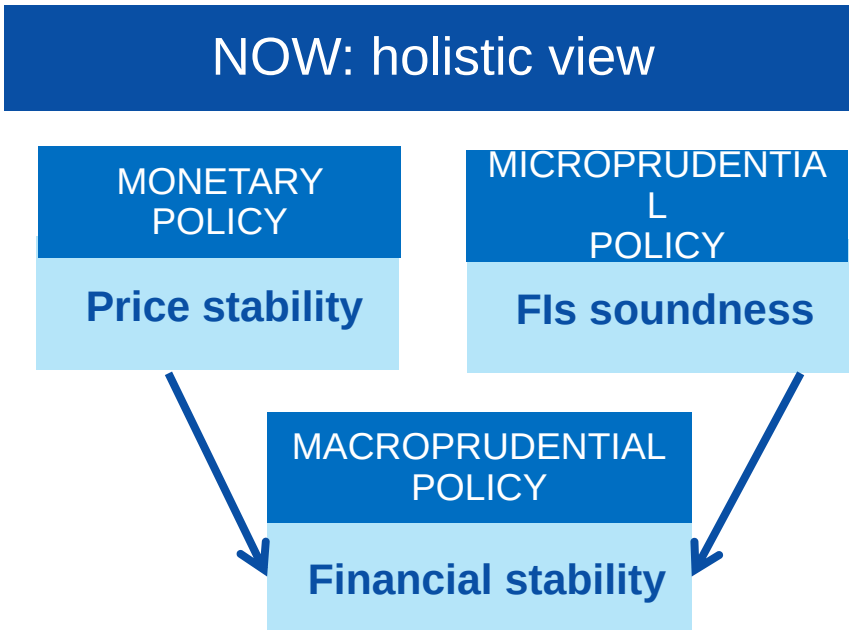
Financial stability

- One objective of macro policies
- Complementary to price stability
- Implicit or explicit in central banks' mandates

Section 1

Basic concepts





- The Macroprudential conceptual framework is not complete yet
  - .. but significant progress towards a better formalization

2 Monetary Policy & Asset Bubbles

Section 2

Monetary Policy & Asset bubbles

Should monetary policy deal with asset bubbles? No consensus

- **Pre- crisis:** no active role. "Mop up after" strategy (Greenspan)
- **Last decade:** intense debate with pros and cons for a more active role of central banks

Arguments in favour

- **Mandate:** CBs tend to have also a financial stability mandate
- **Preserve macro stability:** asset price bubbles threat macroeconomic stability
- **Symmetry:** If CB must act when bubble bursts, then also a role when it is building up

Arguments against

- **False-positives:** asset bubbles cannot be clearly identified ex-ante
- **Effectiveness:** one objective (inflation) is more effective
- **Adequacy:** CB does not have adequate instruments to deal with asset bubbles.

Excessively low interest rates played a major role in the origins of the crisis

Section 2

Monetary Policy & Asset bubbles

Asset price bubbles can be very disruptive, especially if Central Bank response is asymmetric: can saw the seeds of future bubbles

Monetary policy must deal appropriately with asset bubbles, in coordination with macroprudential policy

But using the same instrument (interest rate) to address two different objectives (price stability and financial stability) is a source of conflict

Limits of monetary policy to deal with bubbles enhance the preventive role of macroprudential policy

3 The Macroprudential toolkit

Section 3

The Macroprudential toolkit

A wide variety of macroprudential tools have already been used. Not clear-cut definition of macroprudential domain

	Time dimension (procyclicality)	Cross-sectional dimension (systemic risk)
Capital	• **Countercyclical buffer** • **Dynamic provisions** • **Limits to profits distribution**	• **SIFI capital add-on** • **Levy on non core funding**
Credit	• **Limits to credit growth** • **Dynamic caps on LTV or DTI** • **Dynamic haircuts/margin req.** • **Dynamic leverage ratio**	• **Limits on concentration of counterparty risk**
Liquidity	• **Reserve requirements** • **Minimum margins** • **Liquidity ratios** • **Taxes (FTT)**	• **Caps on FX lending** • **Limits on net open FX mismatches** • **Limits on maturity mismatches**
Structural		• **SIFI resolution requirements** • **Disclosure requirements**

Section 3

The Macroprudential toolkit

Practical experience in the use of these tools is tentative: 3 illustrative examples

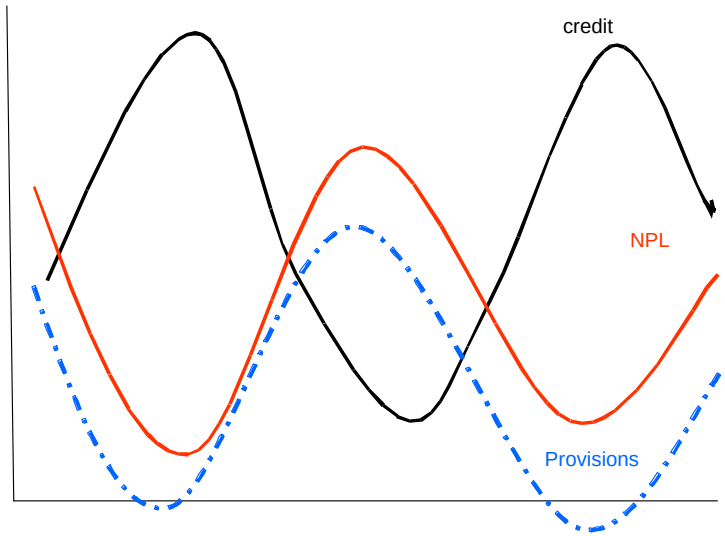
	Description/Aim	Recent examples	Effectiveness
Dynamic provisioning	Provisioning based on expected losses	Colombia Peru Spain	MIXED
Limits to foreign currency lending	Limit credit risk related to FX exposure	Eastern Europe	POOR
LTV/DTI restrictions	Limit leverage/excess indebtedness	Asian EMEs	HIGH

4 Some country experiences

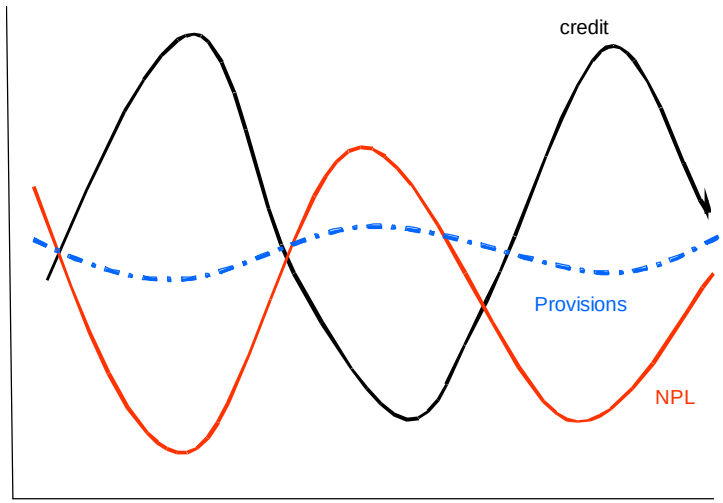
Section 4

Dynamic provisioning: rationale

Normal provisioning



Dynamic provisioning



Section 4

Dynamic provisioning: Latam and Spain

	Spain	Peru	Colombia
Introduced	July 2000	November 2008	June 2007 (commercial) June 2008 (consumption)
Based on	Rule: Credit (stock and growth)	Rule: GDP	Rule based in 4 indicators
Discreet/continuous	Continuous	Discreet (on/off)	Continuous
System vs. institutions	Institution- specific	System-based	Institutions specific
Thresholds	Fund limits: 10%-125%	Potential GDP (5%) implicit minimum threshold. Change in GDP growth also plays a role	Implicit threshold in the provisioning coefficients set by the authorities
Symmetry	Yes, generic provisions can increase or decrease	Yes, "pro-cyclical" provisions can increase or decrease	The use of provisions in the downturn is subject to considerable constraints
Use: individual or general	General. Can smooth profits in the downturn	General. Can smooth profits in the downturn	Individual
Amount	Depends on specific provisions, credit level, credit growth and riskiness of portfolio	Depends on riskiness of portfolio	Depends on specific (individual) provisions and riskiness of portfolio
Tax deductibility	Yes (1% limit)	No	Yes

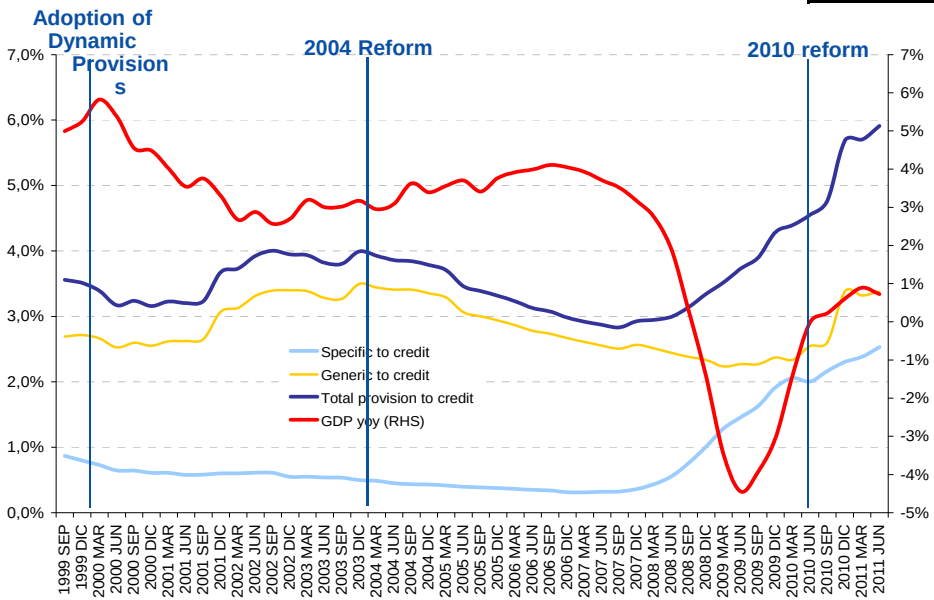
Source: Fernández de Lis and García Herrero (forthcoming in Economía)

Section 4

Dynamic provisioning: Spain

Provisioning to credit and GDP

(As % of credit, left scale, and % GDP growth, right scale)



	Boom phase		Crisis	
	Years	Average credit growth	Years	Average credit growth
Expected	4	13%	4	6%
Observed	8	16%	4+	1%

- **Key problem: calibration of the cycle**
- **Useful as a buffer, less so as a dampener**
- **Did not discouraged credit growth in the boom**
- **Criticism by accounting standard-setters**
- **Reform in 2004 implied lower accumulation**
- **Crisis period: smoothed its impact in the early stages**
- **… but allowed for profits distribution in the downturn: did dynamic provisions delayed the adoption of solutions for ailing banks?**
- **Recently: highly pro-cyclical increase due to market pressure. Asymmetric market discipline**

Section 4

Limits to FX lending: CEE

Vast increase in credit growth:

- **Massive foreign lending through banking system**
- **Mostly channeled to the real estate sector.**
- **Increasing external indebtedness**
- **Centralized foreign banks played a key role**

Boom in overall economy:

- **Housing bubble**
- **Equity markets bubble**

- When available (non EMU), monetary and exchange rate policies used.
- Macroprudential tools used too mostly targeting foreign lending

Section 4

Limits to FX lending: CEE countries

In general, policy reaction was mild and came too late (in the bust)

Policy reaction

- **Authorities complacent**
- **Late adoption**
- **Only a few regulators reacted in time**

Design

- **Higher capital requirements for FX loans:** Romania 2004 & 2010, Hungary 2008, Poland 2008 & 2012, Latvia 2009, Albania 2008
- **Higher LTV for FX mortgage loans** (Hungary 2010) **or DTI** (Romania 2008, Hungary 2010, Poland 2010 and 2012)
- **Outright ban on new FX loans:** Hungary 2010

Results

- **Poor except for Poland, Serbia, Albania**

Section 4

LTV and DTI ceilings in Asian EMEs

Type of macroprudential instrument	Used in
Countercyclical capital buffers (linked to credit growth)	China
Countercyclical provisioning	China, India
Loan-to-value (LTV) ratios	China, Hong Kong SAR, Korea, Singapore
Direct controls on lending to specific sectors	Korea, Malaysia, Philippines, Singapore
Capital surcharges for SIBs	China, India, Philippines, Singapore
Liquidity requirements / funding	India, Korea, Philippines, Singapore
Limits on currency mismatches	India, Malaysia, Philippines
Loan-to-deposit requirements	China, Korea

Source: Caruana 2010 (speech)

Section 4

LTV and DTI ceilings in Asian EMEs

Policy reaction timely and adequate, with better results

Policy reaction

- In general tImely
- Dynamic fine tuning (eg LTV limits were tightened successively).
- Mostly used in conjunction with other measures (monetary policy, capital controls, …)

Design

- LTV limits for mortgages: China, Hong Kong, Korea, Singapore,
- LTV and DTI caps are changed in line with the cycle. Discretion.
- In HK and Korea adjusted to loan size, value and location of property
- Direct controls on lending to specific sectors: Korea, Malaysia, Philippines, Singapore
- Taxes in real estate transactions: China, Hong Kong, Singapore, Korea

Results

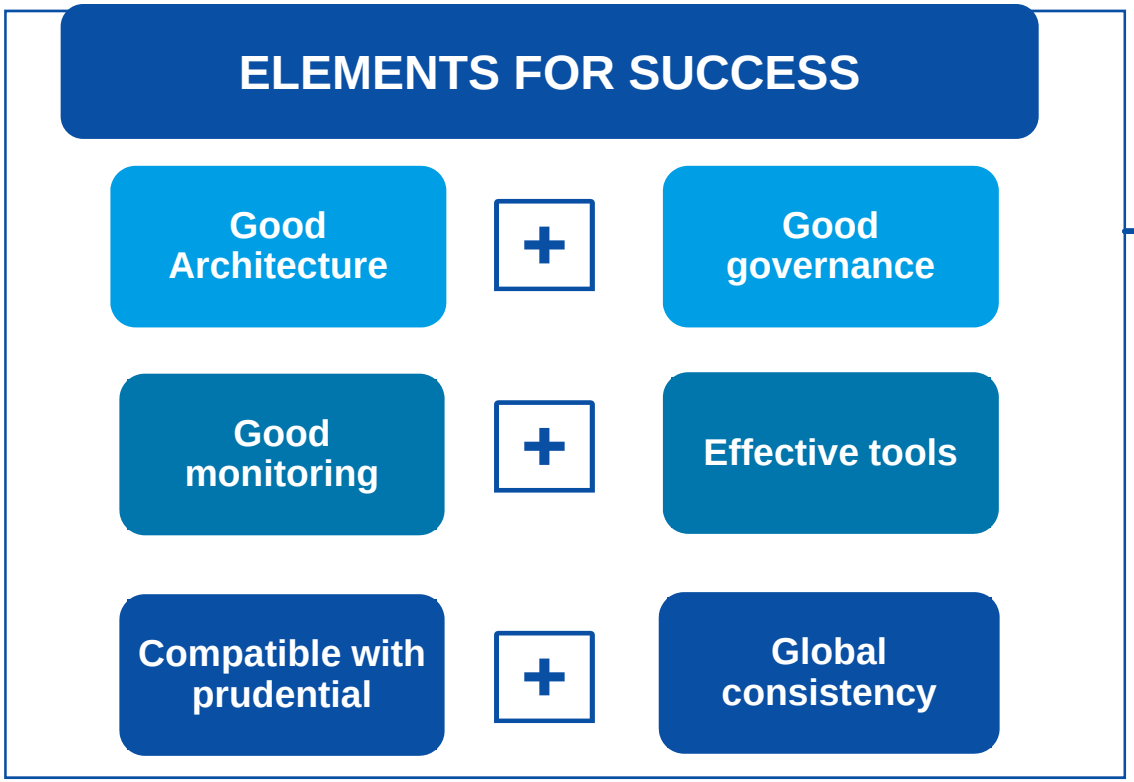
- Helpful to address exuberance in real estate markets but other policies also contributed
- Hong Kong : LTV policy effective in reducing systemic risk
- Evidence in favor of Korean geographical LTVs is positive

5 Lesson from the crisis

Section 5

Main lessons from the crisis

A good design of the macroprudential policy is key for success



- New macroprudential supervisors: EU, US, UK, Mexico, Chile, Uruguay,
- Different architectures and powers but same goal (mitigate systemic risk)
- Central bank tends to have a pivotal role (EU, UK, US)
- Global consistency/coordination must be ensured

Section 5

Main conclusions: a modest Decalogue

1. Macroprudential policies imply an explicit mandate for financial stability
2. The boundaries between macroprudential and macroeconomic policies are sometimes blurred.
3. Important to reduce the burden of financial stability objectives on monetary policies
4. Evidence about effectiveness of macroprudential tools is mixed. Timeliness in adoption of policies is key
5. Monitoring and transparency are key aspects …
6. … but policies that rely on [asymmetric] market discipline are less reliable…
7. …whereas most effective policies are relatively intrusive. Towards an Asian model?
8. Rules-based policies preferable to discretion
9. … but depend on "*ex ante*" calibration of the cycle, which is challenging
10. International coordination important to ensure consistency

Thank you!

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