The interplay between macroprudential and other policies: experience from the UK

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Outline

- Rationale for macroprudential policy and tools
- Macroprudential framework in the UK
- Examples of interaction with other arms of policy

Rationale and tools of macroprudential policy

Pre-crisis consensus

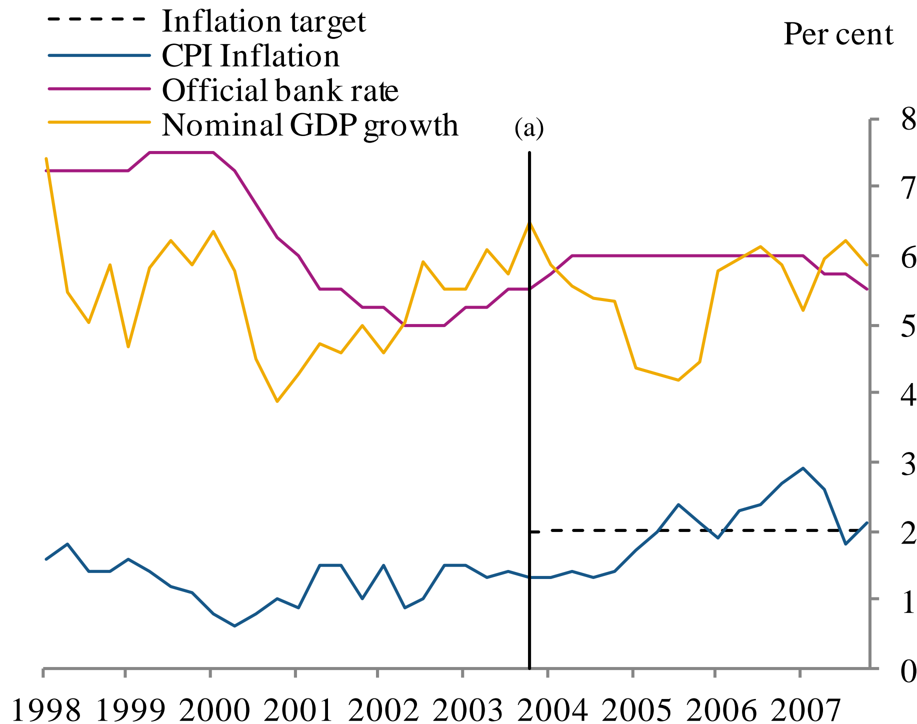
"The notion that a well timed incremental tightening could have been calibrated to prevent the late 1990s bubble is almost surely an illusion." [Monetary policy cannot lean against financial imbalances].

"Instead, we noted…the need to focus on policies to mitigate the fallout when it occurs and, hopefully, ease the transition to the next expansion." [Instead, it can clean.]

Greenspan, A (2002), "Opening Remarks", in *Rethinking Stabilization Policy*, Federal Reserve Bank of Kansas City

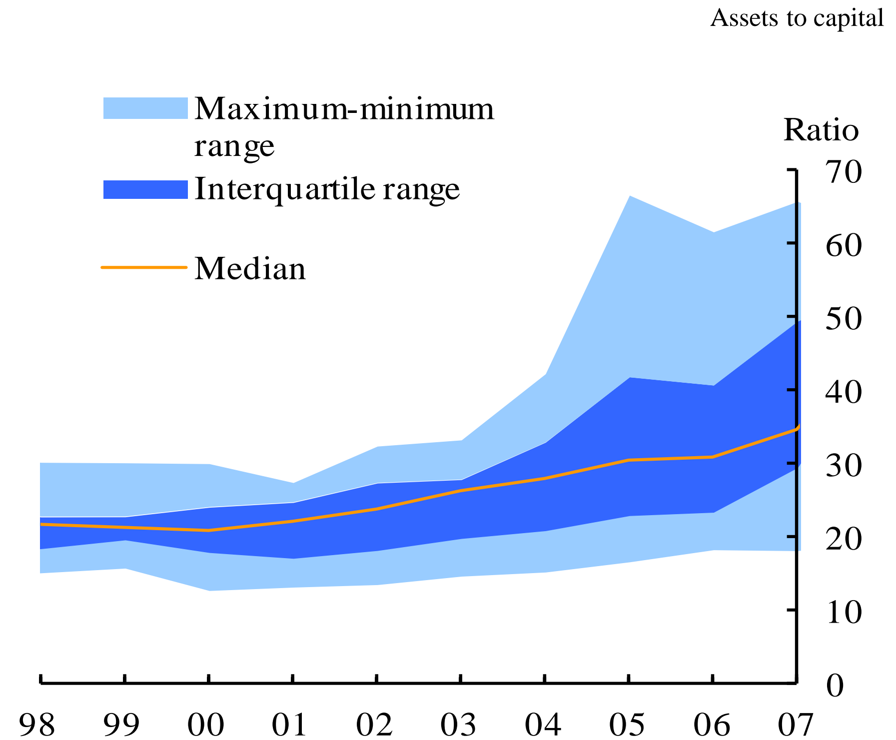
UK monetary policy and financial stability pre-crisis

Real economy stability…



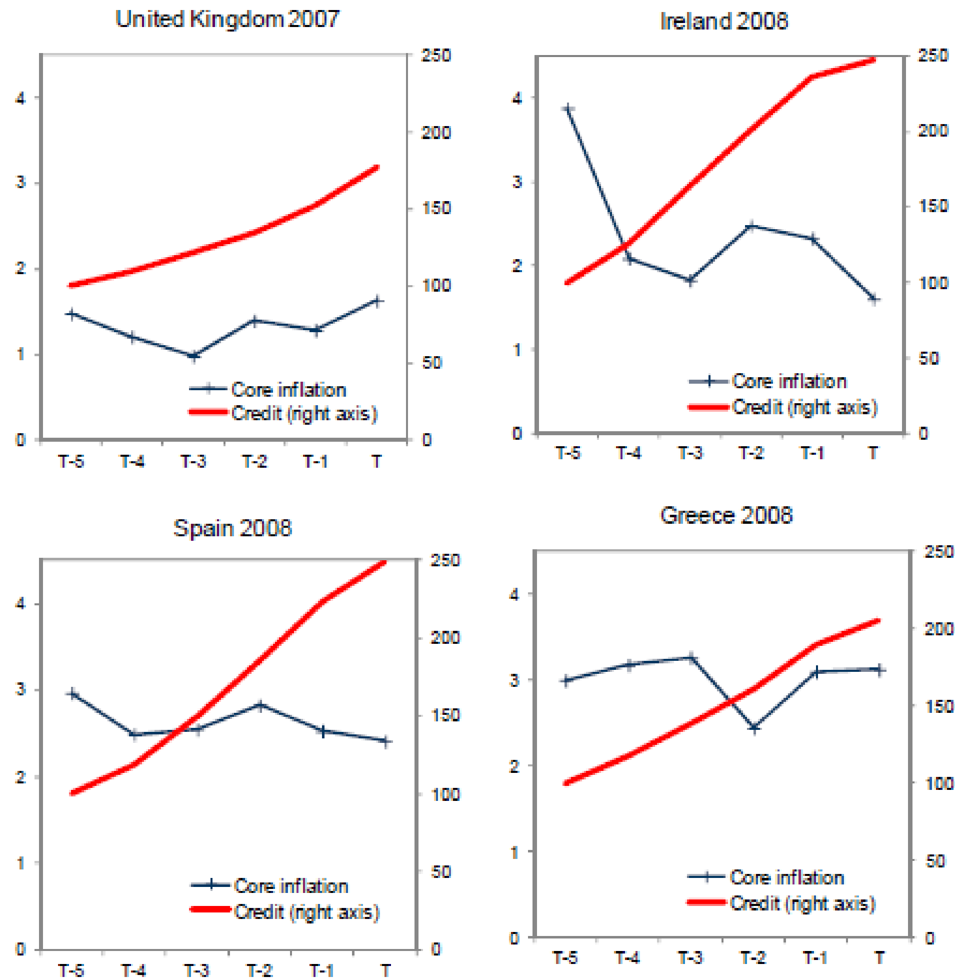
(a) Date MPC shifted to a 2% CPI inflation target

…Financial economy instability



Sources: Published accounts and Bank calculations.

Credit growth and monetary policy elsewhere
Selected countries that experienced a boom in the run-up to the crisis



Sources: IMF *International Financial Statistics*, World Economic Outlook; staff calculations.
Notes: Credit is indexed with a base value of 100 five years prior to the crisis.

Emerging consensus

- Price stability a necessary but not sufficient condition for financial stability
- Use macroprudential policy tools first to build resilience when financial imbalances appear in order to put less pressure on monetary policy to lean and clean
- But macroprudential policy is untested and regulatory perimeter does not extend to all firms: hence do not rule out a leaning role for monetary policy, but not as first line of defence

Eg, Bean, C (2012), "Central banking in boom and slump", JSG Wilson Lecture in Economics, University of Hull; Ingves, S (2014), "Monetary policy and financial stability in a globalised world", speech delivered to the Swedish Economic Association, Stockholm School of Economics, Stockholm; Spencer, G (2014), "Coordination of Monetary Policy and Macro-prudential Policy", speech to Credit Suisse Asian Investment Conference in Hong Kong.

Risk-taking channel of monetary policy

"The idea that regulation can allow the growth benefits of easy credit to come without the costs is a chimera. It is precisely the increases in asset values and increased ability to borrow that stimulate the economy that are the proper concern of prudential regulation."

Summers, L (2014), "Washington must not settle for secular stagnation", *Financial Times*, 5 January.

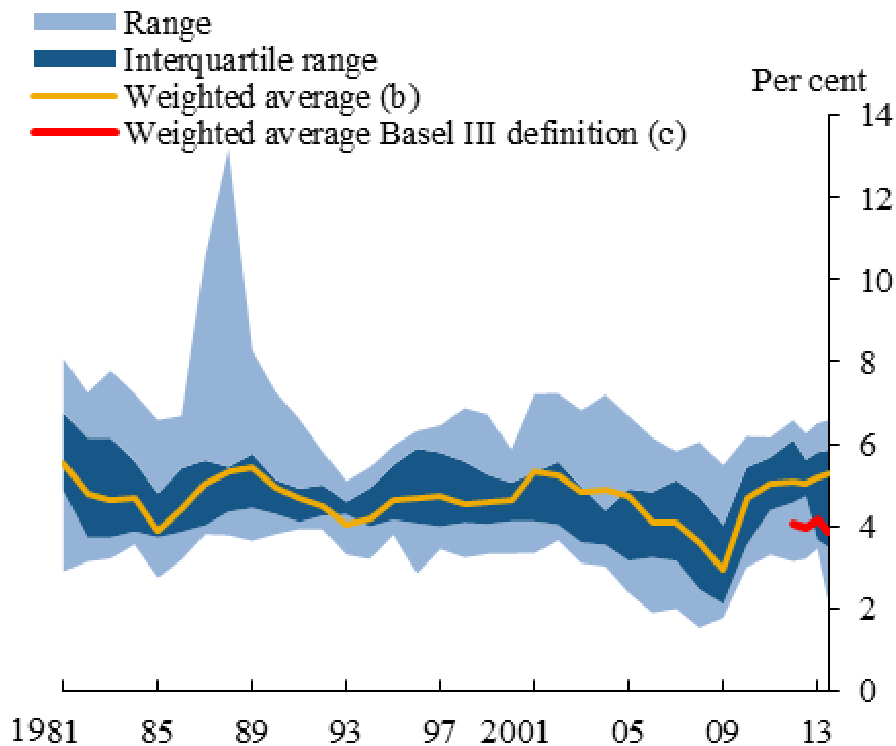
Macroprudential tools to deal with cyclical risk

- Countercyclical macroprudential tools - “time-series” dimension of systemic risk

- Countercyclical capital and leverage ratio requirements; countercyclical sectoral risk weights; countercyclical LTV and LTI ratios; countercyclical liquidity tools; countercyclical margins and haircuts

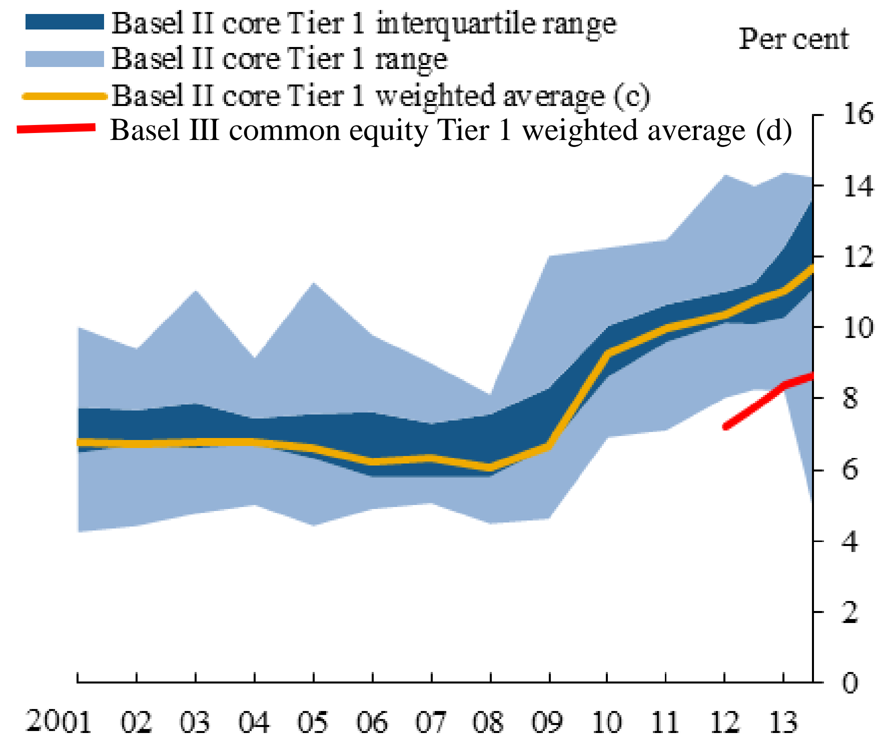
Macroprudential policy and structural risk

Leverage ratio[a]



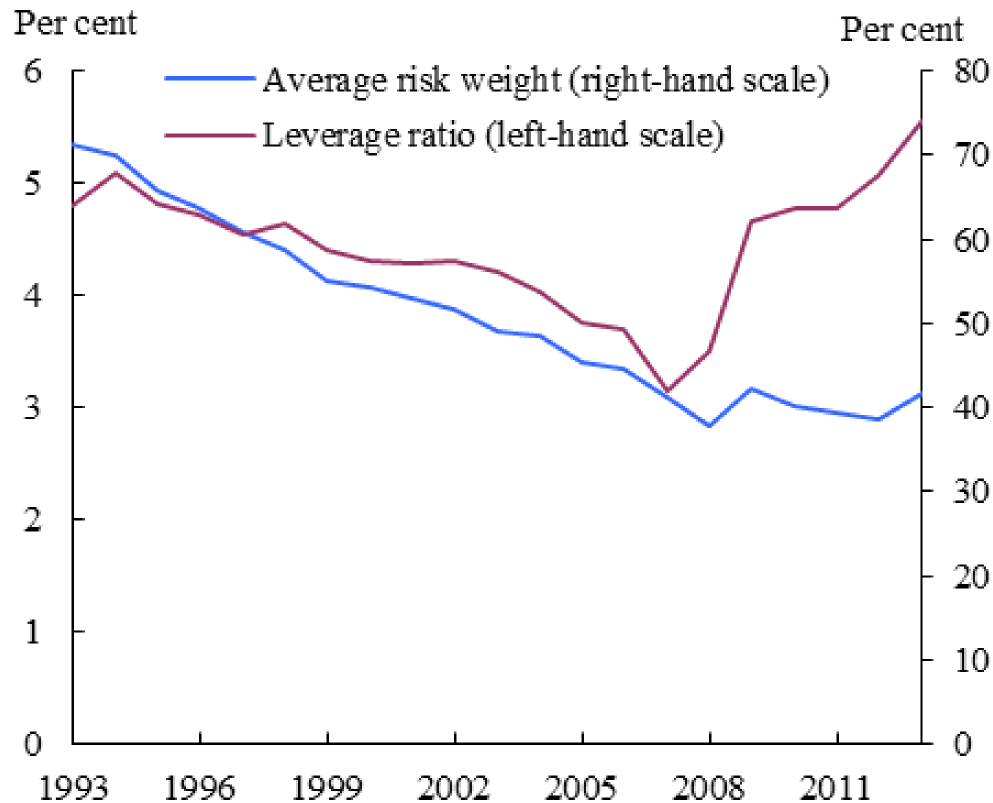
Sources: PRA regulatory returns, published accounts and Bank calculations.
(a) The mean and ranges shown are based on the simple leverage ratio defined as the ratio of shareholders' claims to total assets based on banks' published accounts (note a discontinuity due to introduction of IFRS accounting standards in 2005, which tends to reduce leverage ratios thereafter). Data exclude Northern Rock/Virgin Money from 2008.
(b) Weighted by total assets.
(c) This corresponds to the estimates submitted to the PRA by banks on a best endeavours basis based on the original Basel III 2010 definition (BCBS (2010d)) (aggregate peer group Tier 1 capital over aggregate leverage ratio exposure). During 2013, the BCBS has been reviewing the exposure measure used for the Basel III definition, with a view to publishing a final definition early in 2014. This may differ from the definition used in this Policy Statement. Tier 1 capital includes some 'grandfathered' instruments which will no longer be eligible after the full transition in 2019. The Basel III sample includes Barclays, HSBC, Lloyds Banking Group, RBS, Nationwide, Santander UK and Co-operative Banking Group

Capital ratio[a][b]



Sources: PRA regulatory returns, published accounts and Bank calculations.
(a) Major UK banks' core Tier 1 capital as a percentage of their risk-weighted assets. The series uses the major UK banks peer group as of 2014 and their constituent predecessors. Data exclude Northern Rock/Virgin Money from 2008.
(b) From 2008, the chart shows core Tier 1 ratios as published by banks, excluding hybrid capital instruments and making deductions from capital based on PRA definitions. Prior to 2008 that measure was not typically disclosed; the chart shows Bank calculations approximating it as previously published in the *Financial Stability Report*.
(c) The mean is weighted by risk-weighted assets.
(d) The 'Basel III common equity Tier 1 capital ratio' is calculated as aggregate peer group common equity Tier 1 levels over aggregate risk-weighted assets, corresponding to the Basel III estimates submitted to the PRA by banks on a best endeavours basis. The Basel III sample includes Barclays, HSBC, Lloyds Banking Group, RBS, Nationwide, Santander UK and Co-operative Banking Group.

Average risk weights and leverage ratios since 1996[a][b]



Source: The Banker and Bank calculations.

(a) The series represent the weighted averages across the sample of 17 global banks. Leverage ratio measured as Tier 1 capital/Assets.
(b) Sample includes Bank of America, Barclays, BNP Paribas, Bank of New York Mellon, Citigroup, Commerzbank, Deutsche Bank, HSBC, ING, JP Morgan, Lloyds Banking Group, Royal Bank of Scotland, Santander, State Street, UBS, UniCredit and Wells Fargo.

Other structural fault lines

- Low quality capital resources
- No recognition that systemically important banks need greater loss absorbing capacity to tackle TBTF
- No system-wide approach to stress testing

Macroprudential tools to deal with structural risk

- Structural macroprudential tools - “cross-sectional” dimension of systemic risk
- Leverage ratio requirements guard the system from structural risk-weight under-estimation
- Supplementary risk-weighted and leverage ratio buffers for systemically important banks mitigate the risk of TBTF
- Concurrent stress testing of systemically important banks to inform both macro- and microprudential policy

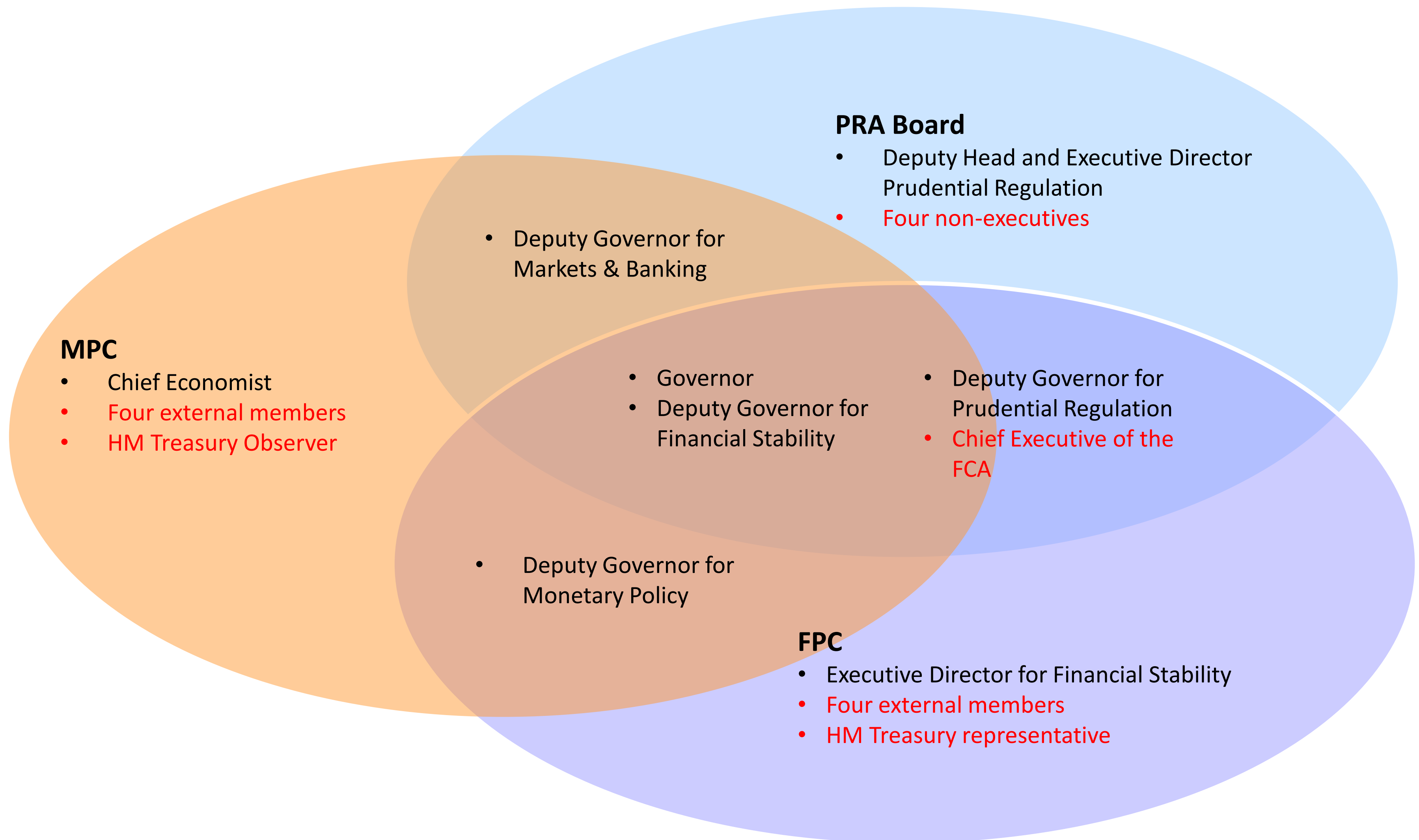
The UK's macroprudential framework

The Financial Policy Committee

Part of wider change to the regulatory architecture in the UK first announced in 2010:

- Creation of a prudential regulator inside the Bank – the PRA
- Creation of a financial conduct regulator, <u>not</u> part of the Bank – the FCA
- Creation of Special Resolution Regime for banks, inside the Bank
- Creation of a macroprudential Committee inside the Bank – the FPC

UK monetary and financial stability framework



Objectives: FPC and MPC

FPC

1. Identify, monitor and take action to **remove or reduce systemic risks** with a view to enhancing and protecting the resilience of the UK financial system.

2. Subject to that, **support the economic policy of the Government** (growth and employment)

MPC

1. Stable prices (2% inflation target) and confidence in the currency

Objectives: PRA and FPC

1. Promote the safety and soundness of banks, building societies, credit unions, insurers and major investment firms and, specifically for insurers, to contribute to securing an appropriate degree of policyholder protection.
2. Subject to that, facilitate effective competition.

In achieving (1), the PRA focusses primarily **on the harm that financial firms cause to the stability of the UK financial system**.

FPC Tools

- Direction powers
  - focussed on countercyclical tools that speak to the 'time series' dimension of systemic risk
  - forthcoming legislation to set supplementary buffers for systemic firm(s) that speak to the 'cross-sectional' dimension of systemic risk
- Recommendation powers
  - used extensively since FPC formed
  - regulatory perimeter
- Evolving toolkit

Examples of coordination

Example 1: FS knockout and forward guidance

- On 7 August 2013, MPC announced a policy of explicit forward guidance
- This would cease to apply if one of three ‘knock-outs’ were breached, one of which – the FS knock out – lies in the hands of FPC
- Breached if “the FPC judges that the stance of monetary policy poses a significant threat to financial stability that cannot be contained by the substantial range of mitigating policy actions available to the FPC, the FCA and the PRA in a way consistent with their objectives”

Example 2: Risks from housing

- In June 2014, the FPC was concerned by the financial stability consequences of a prospective increase in highly indebted households
- Recommended to PRA and FCA to limit the flow of new mortgage lending to high loan-to-income borrowers to 15% of the number of total new mortgages per quarter and made a further recommendation on affordability tests
- Calibration intended not to affect aggregate mortgage activity under the MPC's expected path for inflation and output but to lean against loosening of mortgage underwriting standards => build resilience, whilst allowing monetary policy to support activity
- Involved significant coordination between the MPC and FPC, including joint meetings

Example 3: Concurrent stress tests

- FPC and PRA have been coordinating in the development of the UK variant of major UK banks’ stress tests (to be announced on 16 December)
- FPC will use the stress tests to inform the setting of its countercyclical instruments alongside indicators and FPC judgement
- PRA will use the stress tests and supervisory judgement to inform the setting of its microprudential “Pillar 2” buffer to capture firm-specific risk
- Coordination to ensure no double-counting but also no offsetting of each other’s policy
- Involved significant coordination between PRA and FPC including joint meetings between the PRA Board and FPC

Summary

- UK macroprudential framework consistent with emerging consensus on role of macroprudential policy
- Built-in coordination with monetary policy and microprudential policy
- Knowledge and framework still evolving