



The Role of Macro-Prudential Supervision

by Professor Charles Goodhart

Discussion by

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The opinions expressed in this presentation are those of the author. They do not represent official opinions of the FDIC.

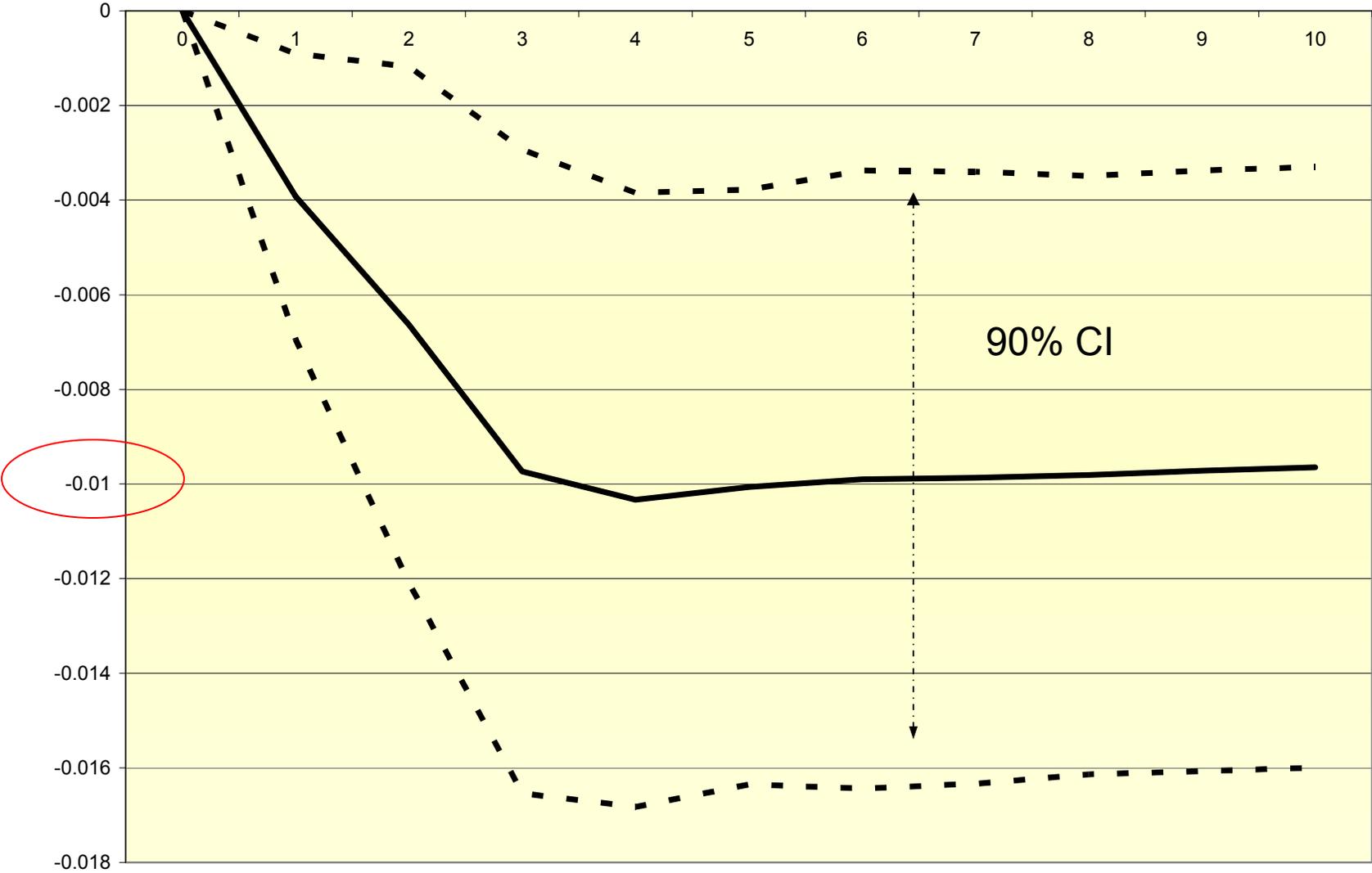
Overview

- Professor Goodhart's paper is an excellent summary of the state of thought on policies related to macro prudential supervision for the financial sector
- I will review some of the arguments and facts related to these important issues and try to ask some of the hard questions these proposals raise....

Basic Issue: Bank Failures have Significant Economic Costs

- History suggests, that absent government intervention, bank failures totaling 1-percent of system deposits will:
 - Decrease IP growth \approx 16.5 percentage points
 - Decrease GNP growth \approx 6.9 percentage points
- As of 2009Q4, 14 individual banks had deposit shares $>$ 1 percent.
 - Source: Kupiec and Ramirez (2010), “Bank Failures and the Cost of Systemic Risk: Evidence from 1900-1930.”

Cumulative Impulse Response of GNP Growth to a 1 Std Dev Bank Failure Shock in the Absence of Government Safety Nets (1900-1930)



Source: Kupiec and Ramirez (2010)

Procylicality Debate...

- Bank failures can have significant effects on GDP growth
- Corollary: Weak banks lend less...and restrict GDP growth
 - Argument behind arguments to relax/forebear on regulations when banks are under stress
 - Encourage banks to lend and spur GDP growth
 - Evidence on this argument is less clear
 - Banks shrink following crisis but is it supply or demand?

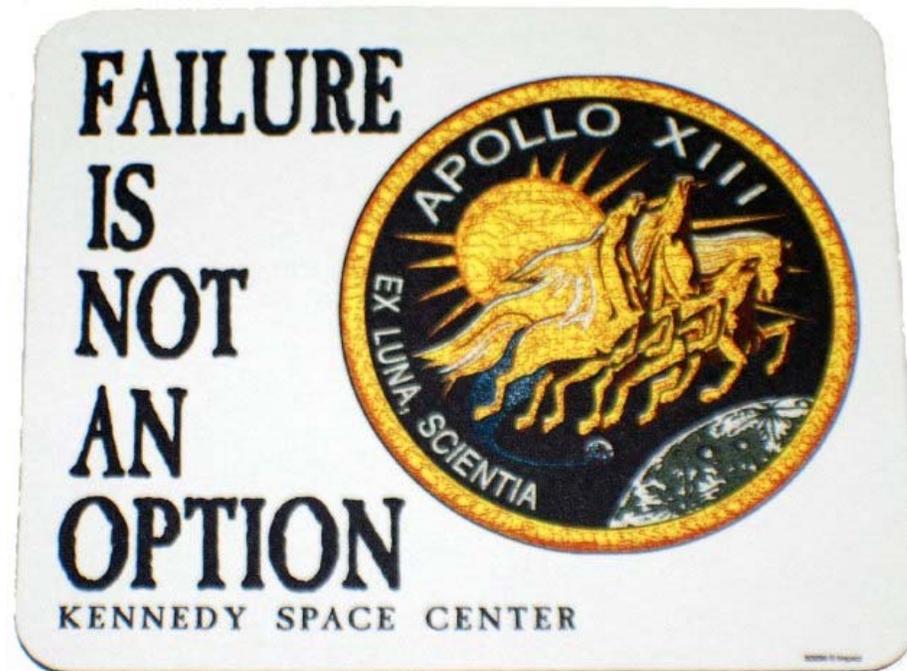
Failure Resolution and Systemic Risk

- An efficient resolution process limits the economic impact of a bank failure.
 - Important policies for limiting systemic risk
- An efficient failure resolution process:
 - Fully liquefies insured claims immediately
 - Sell/transfer deposits and franchise
 - Funds available to conduct a depositor payout if necessary
 - Imposes losses on uninsured claimants and equity
 - Liquefies uninsured claims quickly with holdbacks or “haircuts” for anticipated losses
 - Allows for an orderly liquidation of the failed institutions assets
 - May require access to funding for some period
 - Minimizes probability of “fire sales”
 - Facilitates the transfer of valuable bank relationships to solvent banks

Policies to Address the Costs of Bank Failures

- Policies differ widely across nations

Let me explain the essence of the national differences using a bumper sticker...



The EU Model of Bank Regulation



The UK Model of Bank Regulation



A response to Northern Rock-- SSR became law in February 2009.

UK Special Resolution Regime (SSR)

- The SRR powers allow the authorities to:
 - transfer all or part of a bank to a private sector purchaser
 - Transfer all or part of a bank to a bridge bank - a subsidiary of the Bank of England – pending a future sale
 - place a bank into temporary public ownership (the Treasury's decision)
 - apply to put a bank into the Bank Insolvency Procedure (BIP) which is designed to allow for rapid payments to Financial Services Compensation Scheme (FSCS) insured depositors
 - apply for the use of the Bank Administration Procedure (BAP) to deal with a part of a bank that is not transferred and is instead put into administration
- The FSA, in consultation with the Bank and HM Treasury, makes the decision to put a bank into the SRR.
 - HM Treasury decides whether to put a bank into temporary public ownership
 - otherwise, the BOE, in consultation with the other authorities decides the resolution approach.

The US Model of Bank Regulation

**FAILURE
IS**

*THE
Best*

OPTION



Still Another Recognizable Model of Bank Regulation



Should differences in EU, UK, US and other national resolution policies be reflected in bank sup & reg

- Econ 1=>
 - There should be a balance between resources allocated to limit the costs of bank failure, and resources allocated to prevent bank failures
- **standards?**
- Q: Should capital & liquidity regs be fully harmonized?
 - The US system is designed to handle bank failures
 - Inefficient banks fail and exit the system--regularly
 - Handles many bank failures with modest economic costs
 - US system limitations
 - systemic event—many very large banks become distressed simultaneously
 - Large, non-bank financial institution failures (legislation pending)
 - Failure of a large X-border institution
 - New UK system has been designed to minimize failure costs but SSR is untested (I think)
- At present, the EU seems to require capital and prudential systems that are designed to avoid *any* bank failure

Supervisors are working strengthen
and harmonize international capital
standards to enhance banking sector
stability
....again

Basel II

- The argument for Basel II was that Basel I banking book standards were not aligned with risk and encouraging regulatory arbitrage
 - Story: loan securitization was removing high-risk loans from bank sheets and returning them as highly-rated structured debt with low regulatory capital requirements
 - The true arbitrage play ignored by Basel II was securitization of high risk loans came back to banks as securities in the bank trading book or managed off balance sheet
 - Banks argued these securities were liquid, tradable, and hedge-able and consequently were appropriate for trading book treatment
 - For the most part, bank regulators went along with these arguments
 - Result: Trading books grew
 - No credit risk capital and only 10-day VaR capital!
- On top of this move by bankers to increase leverage, regulators used capital reductions to reward banks for adopting new Basel II risk measurement rules
 - Crisis has shown Basel II capital is too low.....

Basel II “Enhancements”

- Basel Committee initiatives are underway to fix the problem quickly:
 - Strengthen the definition of capital
 - Increase trading Book capital charges
 - Stress VaR, incremental default charge, securitization changes
 - Increase minimum regulatory capital levels (9%, 10% ?)
 - Recognize re-securitizations as separate class
 - Adopt a supplemental leverage ratio
 - Adopt minimum liquidity standards
 - *Procyclicality changes ??*

Enhancements make Basel II even *more* complex

- A fundamental problem is the use of two different horizons (10-day and 1-Year) generate very different capital
 - Trading book “fixes” add significant complication
 - Complexity deters internalization of required risk measures
 - Does complexity create more opportunities for regulatory arbitrage?
 - Difficult to monitor compliance
 - Can supervisors really enforce such a complex set of rules?
 - Do the benefits that accrue justify the required resources for implementation and monitoring?
 - Issues with a re-occurring “regulatory fix”
 - Move to backstop model-based capital rules with stress testing
 - » Ignores the problem that stress testing is a “free form” exercise
 - » No uniform rules or procedures that define an acceptable stress test
 - » Do we get “level playing field”?

Enhancements make Basel II even *more* complex

- Are complicated add-ons to bank capital regulations the best path to improving financial stability?
 - “*Almost all quality improvement comes via simplification of design...processes, and procedures.*” Tom Peters

The Promise of Macro-Prudential Supervision

- Certainly we need to go full speed ahead to develop new and better tools for understanding financial sector risk....
- But are current macro-prudential tools and paradigms reliable?
 - Heavily sold in in national and international regulatory reform programs
 - Systemic Risk Regulators, Councils and Boards

A Spotty Record on Spotting Bubbles?

- How good are economists at identifying systemic risk & financial sector imbalances?



The Promise of Macro-Prudential Supervision

- Our (meaning economists) track record of forecasting financial sector bubbles is “mixed” at best....
- And the efficacy of the proposed non-interest rate macro prudential policy tools is unproven

Let's go to the video tape....

- The tech bubble....from irrational exuberance

Greenspan's speech at AEI December 5, 1996 (emphasis added in excerpt):

[...] Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. **But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?**

Let's go to the video tape....

To a rationalization...computer-driven productivity gains

Greenspan speech to the Economic Club of New York (Jan. 13, 2000).....

"When we look back at the 1990s, from the perspective of say 2010, the nature of the forces currently in train will have presumably become clearer. We may conceivably conclude from that vantage point that, at the turn of the millennium, the American economy was experiencing a once-in-a-century acceleration of innovation, which propelled forward productivity, output, corporate profits, and stock prices at a pace not seen in generations, if ever.

Alternatively, that 2010 retrospective might well conclude that a good deal of what we are currently experiencing was just one of the many euphoric speculative bubbles that have dotted human history."

...mortgage debt is good...

November 13, 2002 Testimony before the Joint Economic Committee of Congress

...mortgage markets have also been a powerful stabilizing force over the past two years of economic distress by facilitating the extraction of some of the equity that homeowners had built up over the years. This effect occurs through three channels: the turnover of the housing stock, home equity loans, and cash-outs associated with the refinancing of existing mortgages. Sales of existing homes have been the major source of extraction of equity. Because the buyer of an existing home almost invariably takes out a mortgage that exceeds the loan canceled by the seller, the net debt on that home rises by the amount of the difference. And, not surprisingly, the increase in net debt tends to approximate the sellers' realized capital gain on the sale. That realized capital gain is financed essentially by the mortgage extension to the homebuyer, and the proceeds, in turn, are used to finance some combination of a down payment on a newly purchased home, a reduction of other household debt, or purchases of goods and services or other assets.

...mortgage innovations create consumer benefits...

Remarks by Chairman Alan Greenspan

**At the annual convention of the Independent Community Bankers of America,
Orlando, Florida**

(via satellite)

March 4, 2003

Home Mortgage Market.....

There can be little doubt that the availability of a ready source of home equity has reduced the costs and uncertainties associated with income volatility, retirement, unexpected medical bills and a host of other life events that can unexpectedly draw down savings. Home equity extraction may be the household sector's realization of the benefit of a rapidly evolving financial intermediation system.

Mortgage bubble...what bubble?

Remarks by Chairman Alan Greenspan

The mortgage market and consumer debt

At America's Community Bankers Annual Convention, Washington, D.C.

October 19, 2004

....Moreover, many have recently become increasingly concerned about the exceptional run-up in home prices. They argue that a collapse of such prices would expose large, recently incurred mortgage debt to decreasing values of home collateral.....

Should home prices fall, we would have reason to be concerned about mortgage debt; but measures of household financial stress do not, at least to date, appear overly worrisome.

Housing price bubbles presuppose an ability of market participants to trade properties as they speculate about the future. But upon sale of a house, homeowners must move and live elsewhere. This necessity, as well as large transaction costs, are significant impediments to speculative trading and an important restraint on the development of price bubbles.

In addition, improvements in lending practices driven by information technology have enabled lenders to reach out to households with previously unrecognized borrowing capacities. This extension of lending has increased overall household debt but has probably not meaningfully increased the number of households with already overextended debt. Finally, the pronounced rise in home equity loans, which have been a growing share of home mortgage debt since 1994, likely reflects the recent marked increase in home equity, the consequence of rapidly rising house prices.

Economists Say No Nationwide Housing Bubble in the US....

Are Home Prices the Next "Bubble"?

NY Fed Economic Policy Review December 2004 Volume 10, Number 3

Authors: [Jonathan McCarthy](#) and [Richard W. Peach](#)

The strong rise in home prices since the mid-1990s has raised concerns over a possible bubble in the housing market and the effect of a sharp price decline on the U.S. economy.... **market fundamentals are strong enough to explain the recent path of home prices and that no bubble exists.**

Assessing High House Prices: Bubbles, Fundamentals, and Misperceptions

Charles Himmelberg, Christopher Mayer, and Todd Sinai

Federal Reserve Bank of New York Staff Reports, no. 218 September 2005

We construct measures of the annual cost of single-family housing for 46 metropolitan areas in the United States over the last 25 years and compare them with local rents and incomes as a way of judging the level of housing prices.... **We find that from the trough of 1995 to 2004, the cost of owning rose somewhat relative to the cost of renting, but not, in most cities, to levels that made houses look overvalued.**

Economists Say No Nationwide Housing Bubble in the US....

- **FDIC 2004: Housing Bubble Concerns and the Outlook for Mortgage Credit Quality**
- ...because home prices have appreciated briskly over the past several years and outpaced income growth, concerns have been voiced about the possibility of a nationwide home price bubble. ...
- **..However, it is unlikely that home prices are poised to plunge nationwide, even when mortgage rates rise.** Housing markets by nature are local, and significant price declines historically have been observed only in markets experiencing serious economic distress.

Maybe some local froth...

- Story from the NY Times May 21, 2005
- MR. GREENSPAN EMPHASIZED THAT HE SEES NO SIGN OF A NATIONWIDE HOUSING BUBBLE, BUT HE ACKNOWLEDGED CONCERNS OVER "FROTH" IN THE MARKET AND POINTED TO A BIG INCREASE IN SPECULATION IN HOMES - PARTICULARLY IN SECOND HOMES. AS A RESULT, HE SAID, THERE ARE "A LOT OF LOCAL BUBBLES" AROUND THE COUNTRY.
- THE COMMENTS OF THE FED CHAIRMAN WERE THE CLOSEST HE HAS COME TO ACKNOWLEDGING THE POSSIBILITY THAT HOUSING PRICES MAY BE POISED FOR A FALL IN SOME PARTS OF THE COUNTRY.

2005.....

- Excerpt from a press article
 - The FDIC revised its report in early May....
 - **FDIC makes a pretty good case through its numbers that the home sale market is overheated but says little beyond "it hardly ever happens" to explain what the future might bring.**

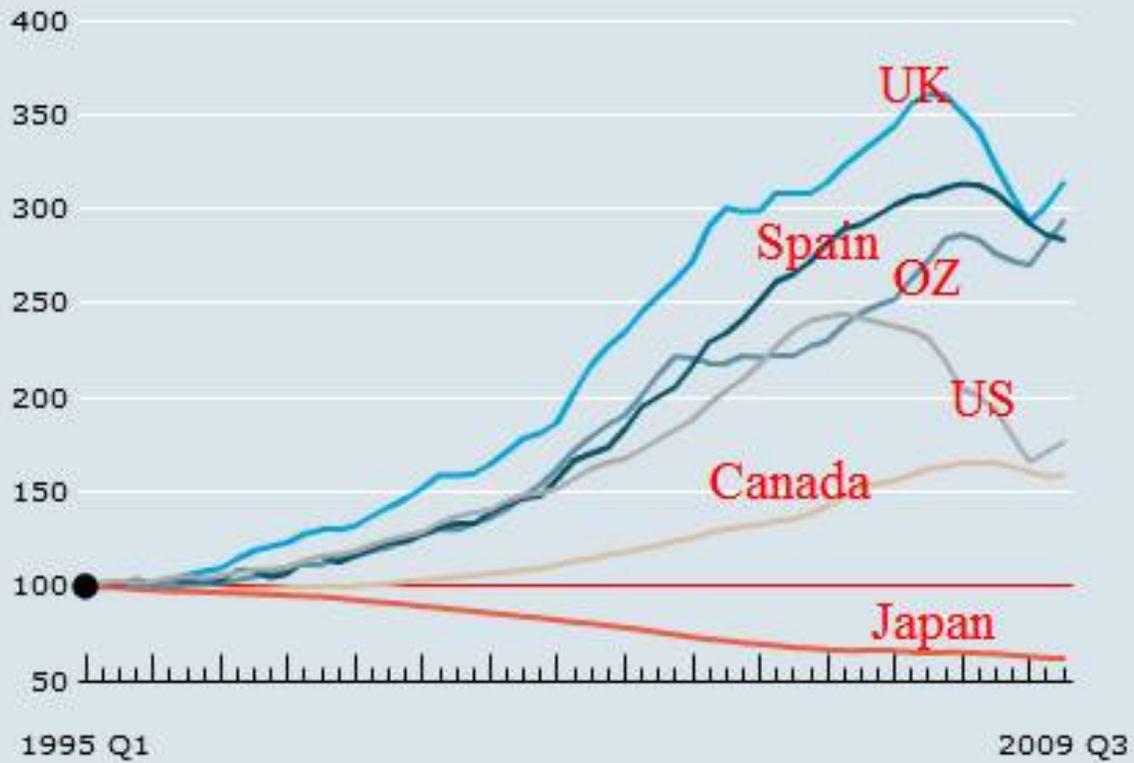
Successful Bubble Catchers...

- Central bank colleagues in Australia, New Zealand and Spain declared a “housing bubble” in their countries...
 - Since 2002, the Bank of Spain began warnings about the overvaluation in housing
 - In 2004, the International Monetary Fund assessment was 20% -30% overvaluation.
 - The Economist est. Spanish overvaluation at 52%.

The Economist house-price indicators

Select series

1995 Q1=100

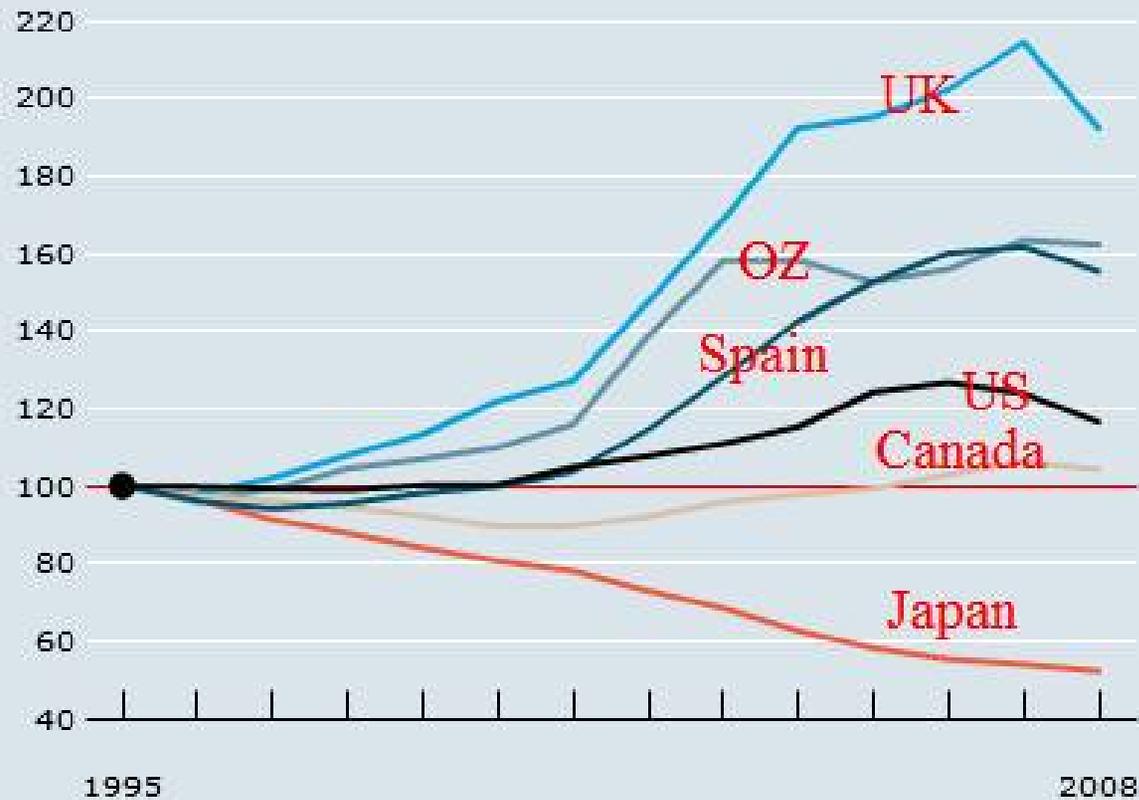


The Economist house-price indicators

Select series

Prices against average income ▼

1995 = 100, income long-term average = 100



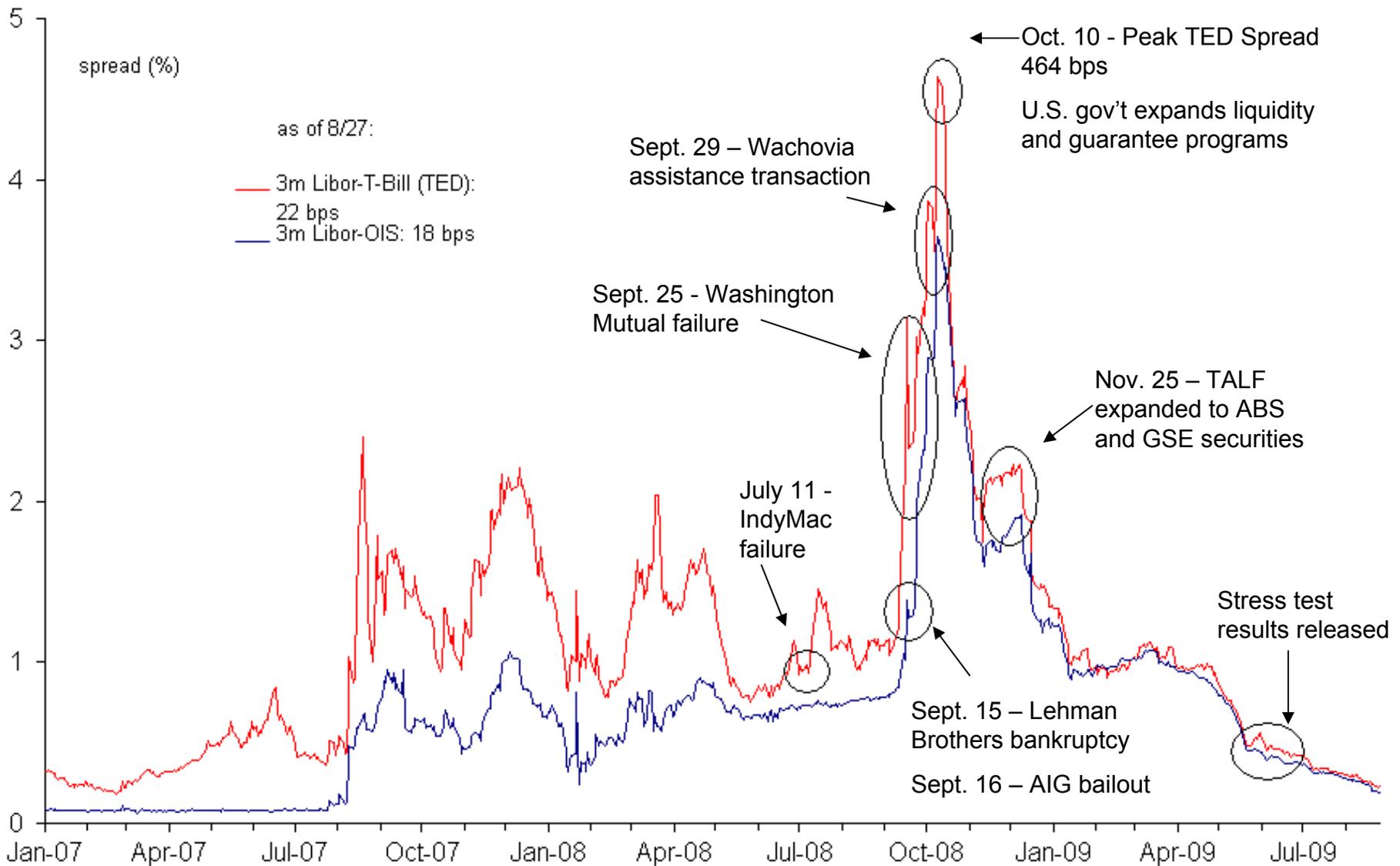
Successful Bubble Catchers...

- The Central Banks of Australia and New Zealand used the “pulpit” *and raised interest rates*
- The Bank of Spain strengthened bank capital and provisioning regulations, but could not raise interest rates
 - The Spanish introduced procyclical provisioning and other tough bank regulatory measures but could not proactively pop the housing bubble

How Good are Our Tools For Identifying Systemic Risk and Systemically Important Institutions?

- Hot new area of research
- Lots of academic marketing
 - In my view, techniques over-promise and under-deliver

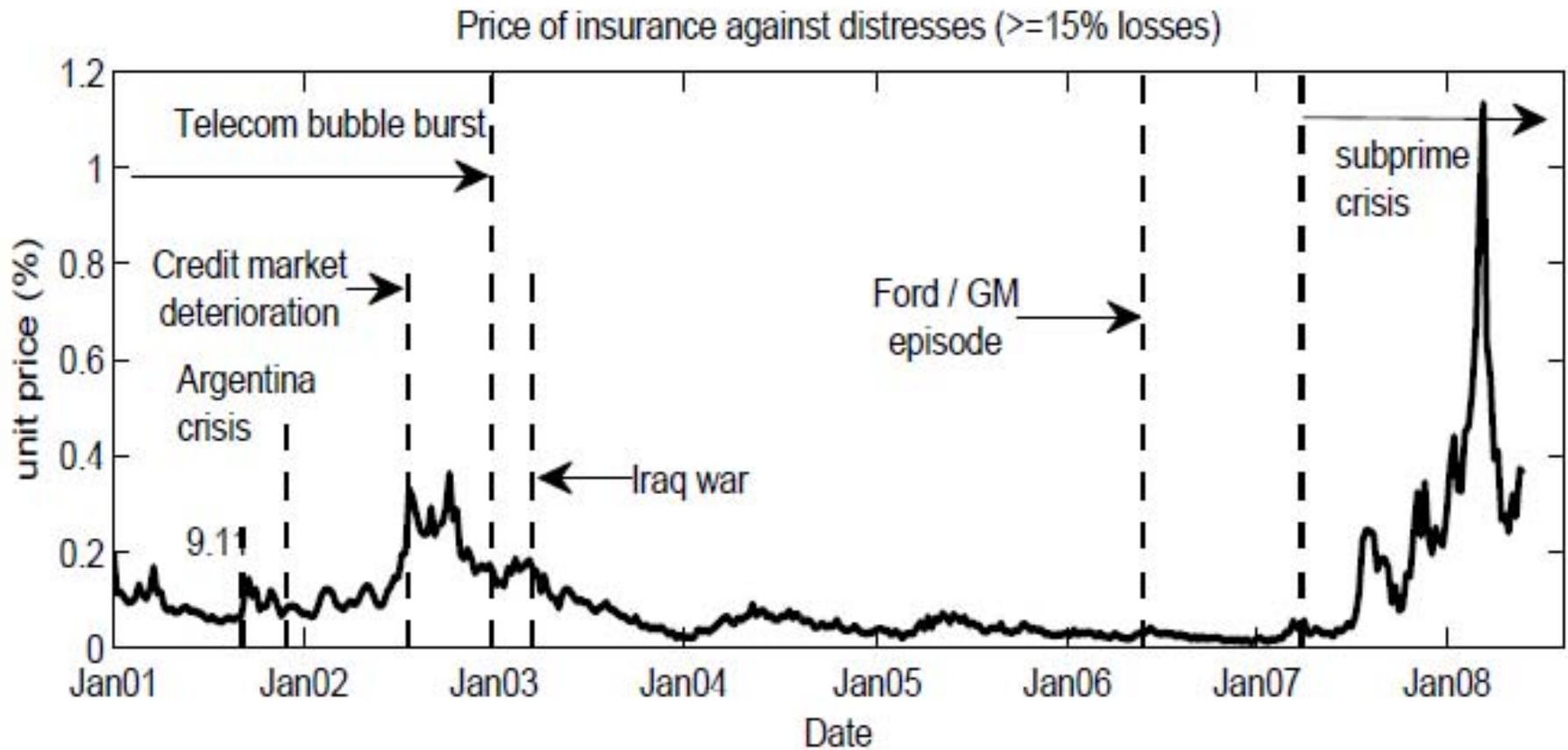
Short Term Rates and Spreads



Source: Bloomberg.

A framework for assessing the systemic risk of major financial institutions†

Xin Huang^{a,*}, Hao Zhou^b and Haibin Zhu^c



Summary: Toward Macro Prudential Supervision

- The ability to resolve banks at minimum economic cost is (IMO) a key to minimizing systemic risk
 - Area where there has been the least progress internationally
 - Have to be able to close weak & failing banks
- As an economist, I have to believe that safety and soundness regs need to balance costs of bank equity capital vs. cost of policies to reduce the economic costs of bank failures
- I do not think this point is widely appreciated in the international capital harmonization discussions

Summary: Toward Macro Prudential Supervision

- The profession's track record at identifying bubbles is weak
 - Find you favorite examples....there are many
- Econometric tools based on market securities prices react way to late to be a basis for early warning systems
- Significant political pressures to “over promise” on stability benefits
 - Bankers may embrace macro-prudential oversight as a substitute for additional institution capital and liquidity buffers
 - Could macro-prudential reforms game the safety net?
- Can variation in bank capital and liquidity buffers really control systemic risk?
 - The contrast between Spain and the NZ-OZ experiences does not support this claim
 - Central banks may have to use interest rates to pop bubbles....