



The nexus of macroprudential supervision, monetary policy, and financial stability[☆]



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ABSTRACT

I discuss changes to bank supervision and regulation since the financial crisis. Microprudential supervision promotes the safety and soundness of individual institutions, while macroprudential supervision focuses on emerging risks to financial system stability. I highlight tools for implementing this macroprudential approach to promoting financial stability, and discuss the interactions and proper relationship between monetary policy and financial stability. While macroprudential tools should be the first line of defense against emerging financial imbalances, in cases where those tools proved to be inadequate to limit risks to financial stability, monetary policy should be considered as a possible defense.

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1. Introduction

I would like to share my perspectives as a monetary policymaker on the important task of fostering financial stability in the post-crisis environment. It may seem strange that the nexus between monetary policy and financial stability is still an open question. The Federal Reserve itself was created a hundred years ago after the financial panics that beset the country in the late 1800s and early 1900s. After the severe 1907 banking panic, the idea that a central bank might contribute to a more stable financial system gained traction and the Federal Reserve Act was signed into law in 1913. Yet, today, after the severe financial crisis of 2008, we are again rethinking the role of central banks in promoting financial stability. In my remarks today, I will highlight some of the changes in the approach to bank supervision we have undertaken since the financial crisis and then discuss the relationship between monetary policy and financial stability in the post-crisis world.

2. Macroprudential supervision

Financial institutions are able to provide valuable credit, risk-management, and liquidity services to businesses and households because they are designed to take risks and are highly leveraged compared with nonfinancial businesses. But this risk-taking and leverage raise the possibility of systemic problems that could threaten the functioning of the financial system, hurt real economic activity, and impose significant economic costs. The pain inflicted by the 2008 financial crisis and deep recession that followed is still being felt by many in our economy. Financial sector supervisors and policymakers can learn many lessons from the crisis and its aftermath, and the country has taken a number of steps to help ensure we do not have a repeat occurrence. The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law in 2010, includes a number of provisions to strengthen the supervisory framework, and financial institution regulators themselves are changing the way they go about monitoring risks. Wanting to promote financial stability is not new, but in addition to microprudential supervision, which promotes the safety and soundness of individual institutions, there is now more recognition of the importance of identifying and monitoring emerging risks to the stability of the financial system as a whole and taking appropriate steps to contain these systemic risks. In this macroprudential approach, examiners and supervisors are taking a more horizontal view in which a particular risk is evaluated across institutions rather than only at one institution at a time.

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Under the Dodd-Frank Act, the Federal Reserve and other financial regulatory agencies were directed to augment the microprudential supervision of individual institutions with a macroprudential approach to supervision designed to address systemic risk. The Financial Stability Oversight Council, with representation from federal and state financial system regulators, was created to coordinate the government's efforts to identify and respond to systemic risks by establishing prudential standards for systemically important firms. The Office of Financial Research, also a product of the Dodd-Frank Act, has the important task of improving the quality of financial data, which are a crucial ingredient supporting policymakers' efforts to better understand the financial landscape and to spot systemic risks.

The regulatory reforms aim to foster financial stability in two ways: first, by lowering the probability of a financial crisis, and second, by reducing the costs imposed on the rest of the economy when a shock hits the financial system. Falling mainly in the first category are the new higher standards for financial institution capital and leverage requirements, liquidity requirements, concentration limits, standards for corporate governance including executive compensation, and the stress tests. Falling mainly in the second category are Dodd-Frank's requirement that a systemically important financial institution provide a resolution plan or living will detailing how it would wind down the firm should it fail, and the act's Title II provisions establishing an orderly liquidation authority to resolve troubled nonbank financial companies. Developing a system to effectively resolve systemically important financial institutions in a way that avoids causing problems that cascade throughout the financial system is a key task on the agenda for promoting financial stability. Ironically, we will have a more stable financial system if we build a system that allows insolvent institutions to fail, and less regulatory intervention to prevent closure of these firms. An effective resolution method will give managers and creditors the incentive to monitor the risks their institution is taking to avoid losses.

Indeed, one of the lessons of the crisis was that incentives matter and regulation itself creates incentives. Sometimes these incentives work to promote financial stability. But sometimes regulations, no matter how well intentioned, can create counterproductive incentives – so-called unintended consequences. For example, at least some part of the strong growth in financial intermediation that occurred outside of the regulated banking system was driven by the desire to avoid regulation. Another example is suggested by the recent discussion surrounding the European Union's cap on bonuses paid to bankers. U.K. policymakers expressed concerns that the cap may not have the desired effect of limiting total compensation, and thereby limiting risk-taking, but instead may result merely in a shift to other types of uncapped compensation, such as fixed salaries, or may spur banks to move operations outside of the EU.

One guiding principle we should follow in any regulation is to pay attention to the incentives created by the regulatory system we have put into place. Explicit and implicit rules and the ways they are implemented create incentives. These incentives influence the behavior of all market participants: the financial intermediaries and their investors and customers, and the regulators. A second principle to follow in regulation is to avoid working against market forces. Instead, we should design a system that harnesses market discipline to work with improved regulation. I view Dodd-Frank's establishment of the OFR to collect financial firm data, as well as the act's permission to compel more public disclosures, as encouraging the transparency needed for market discipline.

Although there is still more work to be done, regulators are making progress in developing tools to implement the macroprudential approach to promoting financial stability. In general, the macroprudential tools can be classified into two categories: structural tools

and cyclical tools. The structural tools aim to build the resiliency of the financial system throughout the business cycle. These tools include the Basel III risk-based capital requirements, minimum liquidity requirements, central clearing for derivatives, and living will resolution plans.

In contrast, the cyclical tools are aimed at mitigating the systemic risk that can build up over the business cycle. The seminal model of [Kiyotaki and Moore \(1997\)](#) shows how these risks can be amplified and propagated. In their model, because borrowers cannot be forced to repay, all lending is collateralized. When the economy is performing well, the value of the collateral increases, which supports further borrowing and higher output. But when a negative shock hits the economy and output declines, collateral values also fall, which means borrowing falls, which depresses output even further. Thus, the collateral constraint is a mechanism that amplifies and propagates the effects of temporary shocks on the economy. [Brunnermeier and Sannikov \(2014\)](#) build on the Kiyotaki and Moore model. In their model, an economic boom increases bank capital levels high enough so that credit is amply available to borrowers. This lowers the volatility of both output and asset prices. The lower volatility induces banks to increase their leverage and lend even more, so much so that the system is now vulnerable to a negative shock. These models illustrate that systemic risk is endogenous, determined by the choices of the model's decision makers, and that systemic risk varies across the cycle.

Macroprudential tools aimed at addressing these emerging risks include the countercyclical capital buffer, the capital conservation buffer, and stress test scenarios. The countercyclical capital buffer allows regulators to increase risk-based capital requirements when credit growth is judged to be excessive and leading to rising systemic risk. The capital conservation buffer ensures that banks raise capital above regulatory minimums in good times so that when they cover losses in bad times, their capital ratio will stay at or above the regulatory minimum. The stress tests can include scenarios that become more severe during strong economic expansions. Other possible cyclical tools, not yet established in the U.S. but used in other countries, include loan-to-value ratio limits and debt-to-income ratio limits that vary over the cycle. In some countries, these macroprudential tools have been targeted at particular sectors like housing credit or household credit. For example, Canada tightened loan-to-value and debt-to-income limits on mortgage lending over the 2009–2012 period ([Krznar and Morsink, 2014](#)). Beginning in 2010, Israel also implemented a package of macroprudential tools to restrict the supply of housing credit ([Fischer, 2014b](#)). Spain introduced dynamic loan-loss provisioning in 2000 ([Balla and McKenna, 2009](#)). This method builds up reserves during good economic times according to the historical losses experienced by the asset classes held in the bank's portfolio. This buffer is then available to absorb losses in bad times.

Assessing the performance of these macroprudential tools is an area of ongoing research. It is complicated by the fact that there is relatively little experience with the use of these tools, and econometrically, it is difficult to isolate the effects of the macroprudential tools from the effects of changes in monetary policy and fiscal policy that occurred at the same time. For example, according to Federal Reserve Vice Chairman Stanley [Fischer \(2014a\)](#), the Bank of Israel did not have good empirical estimates of the effectiveness of the different macroprudential measures. Moreover, gauging success may depend on your metric. While the Spanish banking system had the highest ratio of loan-loss reserves to nonperforming assets in western Europe in 2006 ([Balla and McKenna, 2009, p. 403](#)), and so was in a better position to handle losses, the provisioning did not prevent a housing bubble in Spain. A study by economists at the IMF examining the effectiveness of macroprudential tools in reducing systemic risk in 49 countries found mixed results ([Lim et al., 2011](#)). The authors concluded that many of the most frequently used tools

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