

Macroprudential policy: Some lessons from the pandemic

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MNB-OMFIF Financial Stability Conference 2022, Budapest, 26-27 May 2022

Outline of the presentation

- This time was different
- What was macroprudential in the policy response?
- Findings conditioning the response
- A tentative post-mortem
- Two themes for medium term reflections
 - Vulnerabilities in the NBFIs sector (mainly debt mutual funds & markets where they operate)
 - Usability and releasability of bank buffers

This time was different

- Covid-19 crisis provided first global test to current micro- and macroprudential frameworks emanated from GFC
- In this case, banks were not part of the problem but part of the solution:
 - Non-financial roots of the crisis & perception that banks entered it with stronger financial health allowed authorities to act without fear of rewarding excessive risk taking
 - The policy reaction was quick and decisive on many fronts
 - * lending and market making of last resort
 - * fiscal support measures for the private sector
 - * microprudential forbearance
 - * macroprudential policy (when/where space was available)

– Contrary to common expectations, microprudential supervisors were quite macroprudentially sensitive, partly substituting for lack of macroprudential policy space

Examples:

- * prudential treatment of loan guarantees & moratoria
- * capital implications of IFRS 9
- * Basel III finalization calendars
- * blanket restrictions on distributions

What was macroprudential in the policy response?

- Goals included...
 - keeping corporate sector alive (while impacted by lockdowns & restrictive health policies)
 - providing liquidity to all sectors (including NBFIs)
 - addressing potential downward spirals in financial markets
 - avoiding procyclical mechanisms that could impair credit supply (esp. by banks)
- At first sight, sustaining the corporate sector in a pandemic is more than a prudential objective
 - has fiscal implications & looks like general stabilization policy
 - but massive firings, defaults and liquidations would have caused great damage to financial stability via second round effects

- Yet the nature and size of the interventions raised concerns:
 - Would they create and lengthen the life of zombie firms?
 - Would they interfere with creative destruction, being a drag on the recovery?
 - Would they bring government indebtedness to too high levels?
 - Was existing macroprudential space enough to tackle the crisis?
 - Would resort to microprudential forbearance damage the credibility of banks' prudential frameworks?

Findings conditioning scope & effectiveness of the response

1. NBFIs & related markets were more vulnerable than expected...

- Redemptions faced by debt mutual funds led to fire sales
- Fire sale pricing affected even presumably liquid markets like US treasuries market
- Potential freezing of commercial paper & repo markets might affect banks and NFCs
- Amplification coming from margin calls was still an issue

Implications:

- Looked like the return of the phantom of the GFC [although banks were less vulnerable this time]
- Intervention by central banks brought calm back very soon
- But detected **vulnerabilities should be addressed** in a more structural fashion

2. Regulatory buffers were not as large and releasable as wanted...

- Few jurisdictions had accumulated positive CCyB rates
- Banks looked reluctant to eat on their “management buffers”
- There was capital linked to regulatory buffers (such as CCoB, SyRB, GSII/OSII) not intended to be managed countercyclically

Implications:

- Supervisory forbearance & other measures were used as substitutes for explicit countercyclical tools
- Support for (exceptional) system-wide constraints on distributions (payouts) gained ground
- Two medium-term debates started on
 - (i) **usability & releasability of buffers**
 - (ii) use of payout restrictions as a macroprudential tool

A tentative post-mortem

- Quasi-simultaneous adoption of many measures make assessment of individual measures extremely difficult
[But researchers finding the right identification angle will hopefully shed light on several of them soon]
- More generally, negative micro-outcomes (e.g. high defaults among loans subject to moratoria; opportunistic replacement of non-guaranteed loans by guaranteed ones)...
 - are not necessarily evidence of failure
 - can be seen as second-best costs of interventions with favorable aggregate effects [e.g. sustained employment → lower defaults from households; greater availability of regulatory capital → support to credit supply]

- Overall things seemed to work pretty well
 1. Market maker (or asset buyer) of last resort (MMLR) interventions restored market tranquility at apparently low cost
 2. Extremely low defaults and bankruptcies seen in the corporate sector and moderate growth in corporate leverage suggests that credit support measures were sufficient
 3. Preserved or reinforced strength of banks suggests little compromise in terms of bank resilience
- Somewhat more negatively:
 1. Income preservation at times of restricted supply might have contributed to “excess demand” in the recovery, feeding current inflationary tensions
 2. Governments’ high indebtedness is a source of vulnerability to rising interest rates & spreads
 3. Real estate markets show signs of overheating in many countries

The rest of this talk

My scatter thoughts on two of the highlighted themes

- Vulnerabilities in the NBFIs sector
- Usability and releasability of bank buffers

Vulnerabilities in the NBFIs sector

- Debt mutual funds and, especially, MMFs experienced sizable redemptions in March 2020, producing fire sales, price declines, disruption of primary markets, fear of suspensions,...
 - Recognized underlying factors
 - Their involvement in liquidity (and maturity) transformation...
 - Sometimes w. promise of stable NAV & inadequate allocation of liquidation costs to redeeming investors (→ 1st mover advantage)
 - Triggering events (rise in uncertainty, genuine demand for liquidity) facilitated coordination in runs with self-fulfilling potential
- ⇒ Medium term policy response: removal of stable NAVs, promoting LMT that lead investors to internalize cost of redemptions, stricter asset composition requirements, liquidity requirements

- Less generally recognized issues
 - Tighter bank regulation may have moved liquidity transformation away from banks and banks away from market making
 - Liquidity regulation & unconventional monetary policies have confined large volumes of safe-liquid assets at banks & central banks
- ⇒ Debt mutual funds (and issuers of less safe-liquid debt) are serving otherwise unsatisfied demand for safe-liquid assets
- Classical bank vulnerabilities now affect the NBFIs sector, for which “regular” safety net protections do not exist
 - ⇒ MMLR may have to become regular safety net for non-banks
 - ⇒ Clear lessons for stable coins (=digital versions of MMFs)

Usability and releasability of bank buffers

- The debate was triggered by the frustration coming from
 - limited size of releasable regulatory buffers at the start of the crisis
 - perception, as the crisis advanced, that banks were not “using” (or able to use) at full extent the available buffers
 - Background: Complex regulatory structure implied by Basel III...
 - Minimum requirements
 - Pillar 2 requirements (+ Pillar 2 guidance)
 - Combined buffer requirement (CBR) = CCyB + CCoB + SyRB + GSII/OSII
- together with potential overlaps with other (hard / soft) requirements [leverage ratio / TLAC/MREL / capital needs implied by stress tests]

Terminological note:

- MB = excess of capital on top of that needed to satisfy minimum requirements + the CBR
- Releasable buffer = buffer requirement that authorities have (possibly guided) discretion to release
 - * CCyB is releasable (except if there is a legally binding link to indicators such as credit-to-GDP gap)
 - * CCoB is not releasable
 - * SyRB + GSII/OSII can be changed but are not intended to be “released” for countercyclical motives
- Maximum distributable amount (MDA) = restriction on earnings distribution triggered when capital cannot cover the sum of minimum requirements, Pillar 2 requirements + the CBR

- Tricky concept of *buffer use* = “running down MBs or dipping into the CBR once hit by negative capital shock, to support lending, instead of deleveraging”
 - What prevents the capital to be used to sustain payouts? or to increase assets other than loans? or the risk profile of the assets?
 - How can one identify the “use” of a liability?
 - Banks’ capital management is part of dynamic optimization problem under uncertainty and multiple decision variables & constraints
- Obstacles/disincentives to buffer use include
- Banks’ own prudence (saving for rainy day or better occasion)
 - Fear of breaching the CBR and facing MDA restrictions
 - Fear of being penalized by the market
 - Capability to comply with concomitant requirements

- Informal account of some evidence
 - In the proximity of the CBR: de-leveraging; de-risking; tighter credit conditions; lower pass through
 - Market discipline: unclear impact on availability/cost of debt funding, but...
 - (i) reduction of payouts reduces equity value and may carry corporate governance implications; (ii) banks are concerned about implications of suspending payouts on AT1
 - Banks with low RW densities may find their LR binding if consuming their CBR
- Further analysis should clarify...
 - The relationship between voluntary buffers & regulatory requirements & market requirements
 - The role of payouts

- Policy discussion
 1. Should the CCyB gain relevance as a generic countercyclical tool?
 2. Should other regulatory buffers be restructured / reduced / made releasable?
- Issues conditioning the response
 - Reducing structural buffers conflicts with preserving resilience during contractions
 - Streamlining the buffer framework would be useful [but needs to overcome the tendency to create regulatory tools tailored to the specificities of each new development]
 - What if market-imposed buffers are the ones really binding in bad times?

- Easy things to do?
 1. Enhancing the pro-activity in the management of the CCyB
 2. Preventing that overlaps with other requirements limit the effectiveness of buffer releasability
 3. Removing MDA restrictions for AT1 instruments (or phasing out AT1 as form of going concern capital)
 4. Improving the communication about the path of reactivation (replenishment) of buffers once bad times are over
- Less easy things to do?
 1. Re-structuring the buffer framework (requires global consensus)
 2. Avoiding contradiction between macroprudential measures and supervisory requirements & guidance
 3. Enhancing effectiveness of “capital releases” if market pays attention to headline capital ratios (penalizing deviations from benchmark values)

To conclude

- This lead presentation has been based on a very personal selection of lessons, questions to further analyze, and policy challenges emanated from looking at the macroprudential side of the Covid-19 crisis
- I am sure the distinguished colleagues joining me in the subsequent panel discussion will have lots of interesting thoughts to add on the general topic (and perhaps some of the issues that I raised)
- So let us all hear what the panelists have to say before attempting to extract any final conclusion

[Perhaps we can retake the discussion on issues that I raised later on, including during the Q&A part of the panel discussion]

THANK YOU VERY MUCH!