BANK OF ENGLAND

November 2009

The role of macroprudential policy

A Discussion Paper

The Bank of England would welcome comments on, and criticisms of, the ideas expressed in this paper. Comments should be sent to:

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This paper was finalised on 19 November 2009.

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ISSN 1754-4262

Box 1
The policy debate internationally

This box summarises briefly international initiatives aimed at improving the prudential regulation of banks.

The Basel Committee on Banking Supervision (BCBS) has embarked on an ambitious work programme to improve minimum prudential standards. In particular, the Committee is developing proposals that will improve the risk-capture of capital requirements across banks' trading and commercial banking activities; improve the quality of capital; introduce a leverage ratio as a backstop; and develop, for the first time, an international liquidity standard.

One key dimension of the policy debate is the appropriate level of equity capital in the financial system. It is commonly believed that raising additional equity capital is costly for the banking system and would reduce levels of intermediation. But a higher equity share in the capital structure of a firm need not necessarily imply a higher cost of funding for the banking system because of the reduced risk and hence cost of debt finance arising from lower levels of leverage.[1]

Moreover, some of the reasons given for why higher equity capital could conceivably raise the average cost of capital — such as expectations of government support to protect bank debt holders — are themselves distortions. Removing them would potentially increase the attraction of raising equity. At the same time, there may be some frictions in financial markets that are not so easily removed and which may raise the costs of issuing equity. Against this background, it is clear that further evidence is needed on the costs and benefits of a material increase in required equity capital for the banking system. A recent discussion paper published by the Financial Services Authority (FSA) provides a useful starting point.[2]

A second key dimension of the international debate is mitigating any procyclicality in regulatory requirements. Undesired cyclicality in regulatory ratios can be caused by the use of static ('point-in-time') estimates of probability of default, which tend to fall in an upturn and rise in a recession. The BCBS has developed methodology to track the extent of this cyclicality, which it has begun to apply. Any excessive procyclicality could be reduced by using longer-run averages of default probabilities ('through-the-cycle'). For example, in its implementation of the Basel II framework during the crisis, the FSA has introduced measures which attempt to mimic this smoothing effect.

Another means of mitigating procyclicality in the microprudential regime might be to allow firms to make general provisions against expected future losses as well as incurred losses. The accounting profession is moving in this direction with the recent publication by the International Accounting Standards Board (IASB) of its proposals for replacing the current incurred loss impairment methodology with an expected loss (or cash-flow) approach.[3] The BCBS is working closely with accounting standard setters to help improve banks' incentives to set aside provisions against expected losses. Broadly speaking, a similar principle underpins the so-called 'dynamic provisioning' policy which has operated in Spain for some time, although there are also some important differences (Box 2).

All of these initiatives aim to increase the resilience and reduce the procyclical tendencies of individual institutions. None of them, however, aim to lean against credit exuberance by acting in a forward-looking countercyclical fashion, or to offset risks arising from complex interconnections within the financial system.

More recently, the Basel Committee has developed a work programme to design capital buffers above regulatory minimum requirements that will be built up during credit cycle upswings to be drawn down during downswings. The Financial Stability Board and the BCBS are also developing proposals to address the 'too-big-to-fail' problem, which include assessing the merits of capital surcharges applied to these institutions. These efforts are consistent with calls from the G20 for stronger regulation and oversight of such firms.[4] The UK authorities support these initiatives, which are due to report next year.

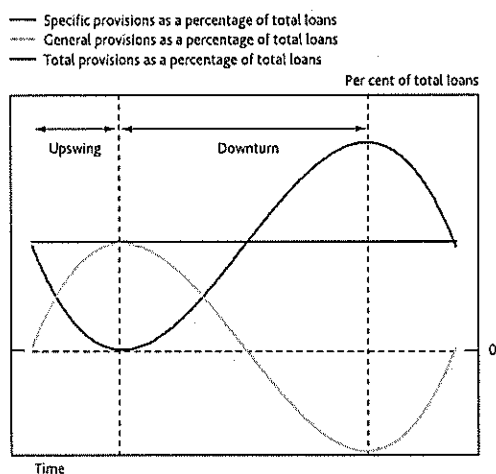
(1) In an economy with no frictions and with no distortionary taxation, it can be shown that the weighted average cost of capital is invariant to the choice of capital structures (Modigliani and Miller (1958)).
(2) FSA (2009b).
(3) See International Accounting Standards Board (2009).
(4) See www.g20.org.

Box 2
Is dynamic provisioning sufficient to meet macroprudential objectives?

There has been considerable recent interest in the regulatory regime of 'dynamic provisioning' introduced by the Spanish authorities in 2000. This is a rule-based scheme that requires banks to build up buffers of general provisions (also referred to as 'dynamic' or 'statistical' provisions) against performing loans in an upturn, which can then be drawn down in a recession. Under the Spanish system, general provisions are intended to complement specific provisions made against loans which already show signs of impairment.

To see how the system works, consider the following stylised example. When a bank in Spain extends a mortgage, it must set aside a provision consistent with the historical loss experience of that type of lending, even though the particular mortgage itself may show no current sign of impairment. By using long-run historical losses, general provisions are intended to counter the natural procyclicality of specific provisions, ensuring smoother total provisions over the cycle (Chart A). In this way, dynamic provisions can contribute towards making the banking sector more resilient to expected losses and as a result less cyclical. By contrast, the role of macroprudential instruments would be to increase the resilience of the financial system to unexpected losses and be countercyclical by design.

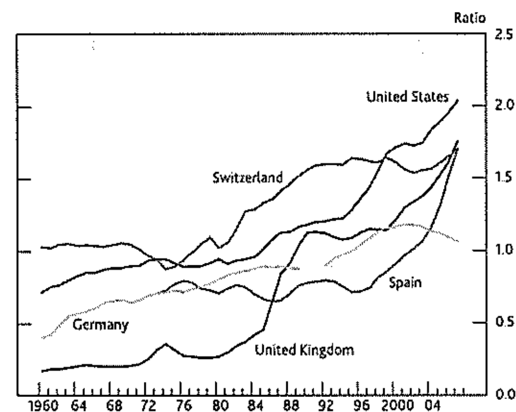
Chart A Dynamic provisioning: a stylised illustration



Dynamic provisioning is essentially a rule for setting aside reserves based on stocks and flows of credit. The parameters of the Spanish rule have been fixed since 2004 and were calibrated to capture average historical incurred losses (a proxy for long-run expected loss) in different lending sectors. As a fixed, backward-looking rule based on historical losses, the scheme is not designed to respond to financial shocks in a flexible way. For example, a backward-looking regime, by definition, cannot distinguish between credit demand and supply shocks.

Experience in Spain has shown that dynamic provisioning does little to smooth the supply of credit. As **Chart B** illustrates, since the introduction of dynamic provisioning in 2000 the ratio of private credit to GDP in Spain has more than doubled, growing at a faster rate than in the United Kingdom, United States, Switzerland and Germany. But Spanish dynamic provisions may have contributed towards increasing the resilience of the Spanish banking sector, forcing banks to build up buffers against particular types of lending.

Chart B Ratio of private credit to GDP in selected countries[(a)]



Source: World Bank.

(a) Private credit defined as claims on the private sector by deposit money banks and other financial institutions. It excludes credit issued to governments and public enterprises. The ratio is designed to measure the activity of financial intermediaries in channelling savings to investors. Measured on a real (deflated) basis.

Dynamic provisioning as currently implemented in Spain applies only to exposures held in the banking book. It does not capture exuberance in other parts of the balance sheet, such as trading book holdings of securitised products.