



MAX-PLANCK-GESELLSCHAFT

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Macroprudential Policies: What Do We Know?

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Innovations after the Global Financial Crisis



- Systemic Risk Analysis
- Macroprudential regulation and policy
- By now almost routine.
- But:
Do we know what we are doing?

What is „macroprudential“?



- Since the term appears in the Regulation establishing the European Systemic Risk Board, the lawyers what it means!
- A Potpourri of measures listed in ESRB surveys?
- NOT microprudential – Crockett, Supervisors ... what Spain did in the years after 2000!?
- ... what we should have been doing in the years before 2007? But what precisely was that?
- Anything national authorities want to do that comes on top of the EU's harmonized rule book?

Macroprudential Policies



- Capital Surcharges, LTV Ratios, Forbearance (?)
- Macro?
- ... How do they relate to monetary and fiscal policy?
- Problem: Macro-Pru is not really a policy of its own but a dimension of other policies
- Discretionary: Decisions depend on political economy, delays to be expected

Two examples



- Germany: Countercyclical capital add-on announced after lengthy discussions in late 2019, to take effect in mid 2020, rescinded in March 2020 – lack of political will
- ESRB report on foreign currency lending to individuals (2012) gave Eastern European authorities support for restricting such lending, which much softened the impact of the 2015 Swiss franc revaluation, at least for Poland.

A More Recent Example



- From March 2020 to March 2022, many US banks took large, uninsured short-term, deposits and invested in long-term securities.
- From March 2022 on, investors slowly moved back out of deposits and into money market instruments
- Authorities failed to appreciate the significance of these developments, the interest rate risk taken on 2020-22, and the effects of 2022 interest rate increases on (i) investors' incentives and (ii) bank solvency.

A More Recent Example ctd.



- Authorities took the banks' accounting numbers at face value, without appreciating that HTM classifications might not be sustainable if depositors leave.
- Therefore they treated the crisis of March 2023 solely as a liquidity crisis, without appreciating that the run on SVB was triggered by a perception that the bank's insolvency would be laid open the drain on deposits forced a sale of HTM securities.
- Support given this spring is all for liquidity, but with liquidity support at 5% and 2021 investments yielding 1.5%, there still is a solvency problem.

Interest Rate Risk



- Interest rate risk is fundamental
- SVB crisis has parallels to S&L crisis in the 1980s
- Yet, accounting rules and regulation fail to take account of it – if it concerns HTM assets (bank book)
- For assets in the trading book, fair-value accounting is applied, but hedge contracts neutralize the regulatory impact.
- Adjustable-rate clauses, however, caused insolvencies in the late 1980s (US and UK) and in 2006-2009 (subprime mortgages)

The need for a better conceptual framework



- „Interest rate risk“ as a market risk for tradeable securities

versus

- „Interest rate risk“ as a risk of changes in a **fundamental factor** that affects many risks at the same time, availability of funding, costs of funding, market value of securities, fair value of non-tradeable assets, counterparty credit risk in derivative contracts...

Macro Shocks, System risk, and contagion



- Macro shocks are fundamental to systemic risk
- System risk through parallel exposures to macro shocks
 - Examples: US S&Ls, Sweden, Japan, Thailand, US 2023...
- Contagion through hidden macro risks
 - Example: Thailand, 2007 – 2009
 - Macro risks hidden in correlated counterparty credit risks: Thailand, AIG
 - ... And in firesale externalities

What is Macro-prudential Analysis about



- „Cycle“ vs. systemic risk
- „macro“?
- Real economy, financial, or real assets?
- Example: Interest rate risk: Early 1980s, Late 1980s/early 1990s, mid 2000s
- Exchange rate risks? Business cycle risks?

Narratives vs. Models



- Limited Usefulness of quantitative models
- What is the STORY?
- Macro risks must be somewhere? Where are they hidden? (SVB versus subprime!)
- Contagion risk is hardly predictable:
 - Contractual dominos
 - Loss of contracting opportunities
 - Information contagion (hysteria contagion?)
 - Fire sale externalities

Example: The Lehman Crisis



- Suspicions about Lehman losses in warehousing motivate short sales of shares
- Information about losses in warehousing causes repo run
- Repo run forces Lehman in to insolvency
- Lehman Insolvency causes Reserve Primary to break the buck
- Run on money market funds
- Run by money market funds, breakdown of interbank funding
- Scramble for cash, Asset price implosion

Assessing system risk exposure



- We are talking about a multiplicity of effects
- ... in a highly nonlinear system
- ... which probably has multiple equilibria
- ... in which there is no transparency about the other participants's positions
- ... in which the different participants' positions are changing all the time, and credit risks are endogenous...

Assessing system risk exposure 2



- Short data series
- For a nonstationary set of phenomena
- In which hidden correlations play a central role
- Where these correlations are changing all the time
- And are endogenous...

Macro-prudential analysis ctd.



- What is the role of asset markets?
- Deleveraging: Slow and fast
- Different time scales for different processes?
- Corrective measures at the level of stock variables?
- General equilibrium question: Who can be the counterparty to deleveraging
- The failure of macroeconomic models – even now!!!

Conflicting Objectives



- Financial stability or macro stability?
- Coincide on the upswing, in conflict in a crisis
- If banks are weak and the economy is weak, what should be done?
- Prioritize financial stability and get the banks in shape again? (Greenspan 1990)
- Use forbearance to reduce procyclicality of current regulation!?
- Or beware of excessive forbearance, which may cause undue delay in cleaning the mess up?