ECB - Fourth Macroprudential Policy and Research Conference

Policy Panel

Presentation by Vítor Constâncio

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I will address the first two questions put forward by the organizers

- What are your views on the effectiveness of counter-cyclical capital measures?
- Where should efforts to complete the macroprudential toolkit be concentrated (a) within the banking sector, and (b) within the non-banking sector?

OUTLINE

1 – CCyB

1.1 Objectives and effectiveness of the CCyB

1.2. Early build-up and the advantages of a positive neutral CCyB level in normal times

1.3 Problems with the release of the CCyB

1.4. Governance and coordination of Macroprudential and Microprudential Policies

1.5. CCyB calibration and the creation of space for an immediate increase

2 – Completion of the Macroprudential toolkit and the boundary problem

2.1. Banks under siege from regulation, policies and less regulated competitors

2.2. Macroprudential tools for non-banks:

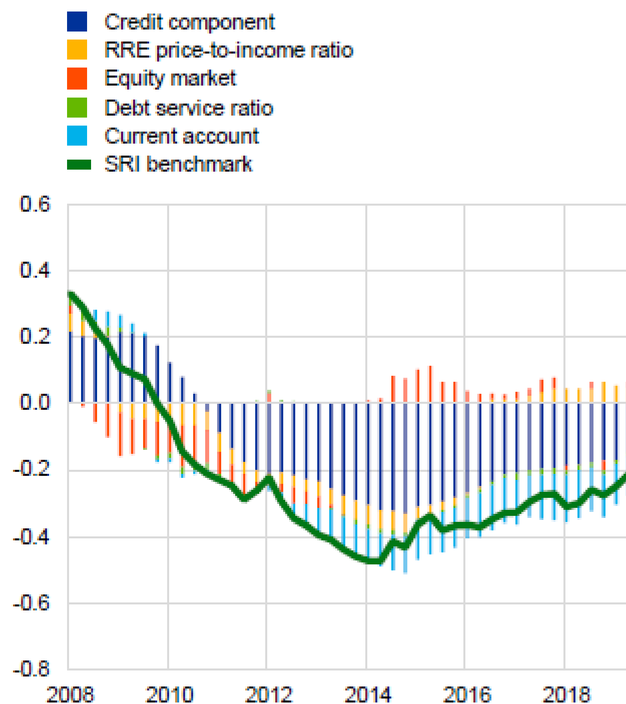
a) **Margins and haircuts for OTC derivatives and SFTs**
b) **Leverage limits**
c) **Liquidity tools**

2.3. The "boundary problem" and the banks' franchise

Despite a drifting up of cyclical risk, the countercyclical capital buffer still only forms a tiny fraction of euro area banks' capital requirements

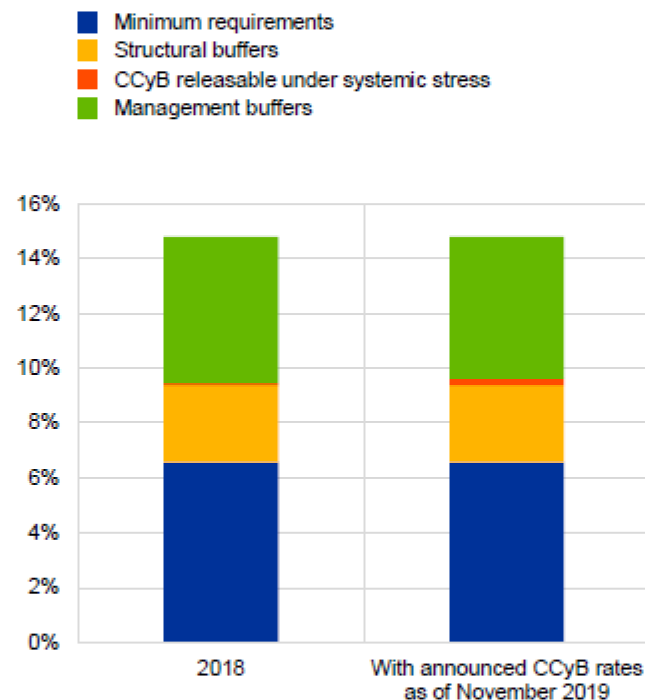
Euro area systemic risk indicator (SRI) and contributing factors

(Q1 2008-Q2 2019, deviation from historical median in multiples of standard deviation)



Common Equity Tier 1 (CET1) requirements, and macroprudential and management buffers

(percentages and percentage point contributions)



Sources: ECB, Eurostat and ECB calculations.

Source: ECB FSR Nov 2019

1 – CCyB

1.1 Objectives and effectiveness of the CCyB

1.2. Early build-up and the advantages of a positive neutral CcyB level in normal times

Advantages of adopting a small (e.g.1%) positive CCyB in normal times:

a) **Helps to overcome recognition and implementation lags in case a stressful situation is coming**

b) **Helps against type I errors of missing a coming crisis**

c) **Makes easier the gradualism to complete the buils-up**

In 2017, there were technical discussions to introduce a positive neutral CCyB in the EA but only a few countries decided then to go ahead. Now 7 countries apply CCyB from 0.25% to 1.5%. If a real economic slowdown is coming it would be useful that all countries had some buffers to release in order to mitigate negative developments in credit supply. The fact that monetary policy is now constrained, makes macroprudential tools more necessary and important. Desirability of higher capital buffers to be released when a significant downturn happens.

- **1 – CCyB**
- 1.3 Problems with the release of the CCyB
- 1.4. Governance and coordination of Macroprudential and Microprudential Policies

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1- In case of stressful situations, an early release of capital buffers is advisable to prevent possible later credit crunches. There are however uncertainties surrounding capital buffers releases for two reasons:

a) Microsupervisors may be against it, in some cases even wanting to increase capital requirements in stressful situations (e.g. via Pilar2)

b) Markets may penalise with higher funding costs the banks that reduce their capital ratio as a consequence of the release.

A signal of microsupervisors reluctance in the EU is the fact that in the adverse scenario of stress tests there is no formal threshold but the banks that don´t reach 9% are supposed to need immediately to reinforce their capital positions for that not materialized tail risk. In the US stress tests the capital threshold for the adverse scenario has always been just 5%.

These uncertainties about the release of capital buffers are another reason behind the preference for borrower-based macroprudential tools as more effective.

- **1 – CCyB**
- …
- 1.4. Governance and coordination of Macroprudential and Microprudential Policies

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A significant degree of coordination is necessary between Macroprudential and Microprudential authorities for the Macroprudential standpoint to prevail in a timely fashion.

Governance in the EA is not ideal in this respect. At the ECB however, in the domain of its competences it is important to highlight that : "The ultimate decision-making body in the SSM is the Governing Council, which is also in the lead for macroprudential policy... The Macroprudential Forum, composed of the members of the Governing Council and the Supervisory Board, operates as a platform for regular discussion at the highest level, bringing together the micro- and the macroprudential perspectives "

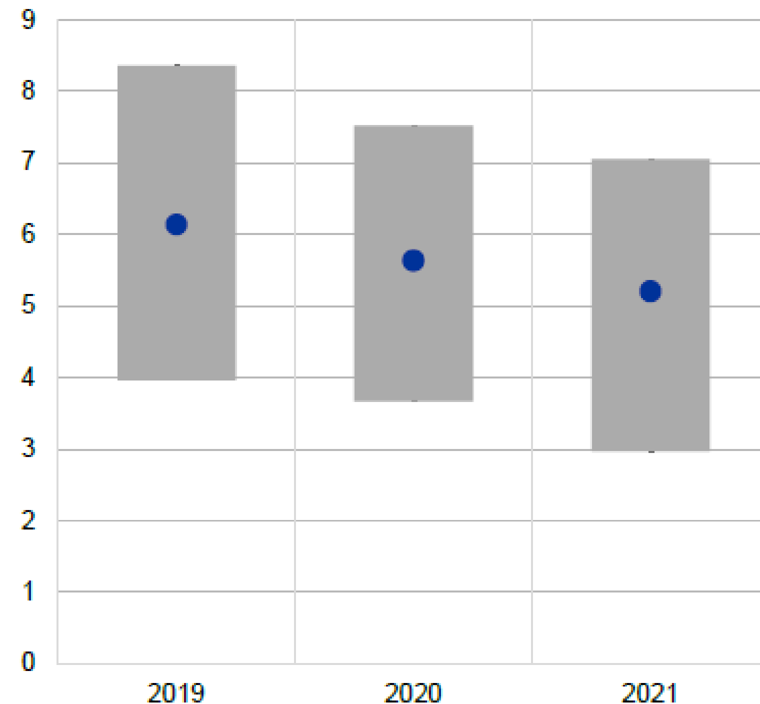
- **1 – CCyB**
- ...
- 1.5. CCyB calibration and the creation of space for an immediate increase
- In the US, a concept of Stress Capital Buffer (SCB) is being created that will include the CCoB, the capital requirements from stress-tests and the CCyB. A permanent minimum floor of 3% (0.5% above the Basel III CCoB) has been proposed for discussion (See speech by FED Vice-Chair R. Quarles on September 5, 2019) . Going above 3%, higher levels of CCyB are accommodated.
- In Europe, a virtual SCB concept, could include the P2G , the CCyB, the CCoB and the SyRB. Keeping the present level of capital (and the SCB), the CCyB part could be now increased and being offset by reductions in P2G and/or the SyRB, thus increasing the component that could be later released in case of materialisation of a significant slowdown.

- **2 – Completion of the Macroprudential toolkit and the boundary problem**
- 2.1. Banks under siege from regulation, policies and less regulated competitors
- 2.2. Macroprudential tools for non-banks:
    a) Margins and haircuts for OTC derivatives and SFTs
    b) Leverage limits
    c) Liquidity tools
- 2.3. The "boundary problem and the banks' franchise

Low profitability prospects continue to weigh on bank valuations

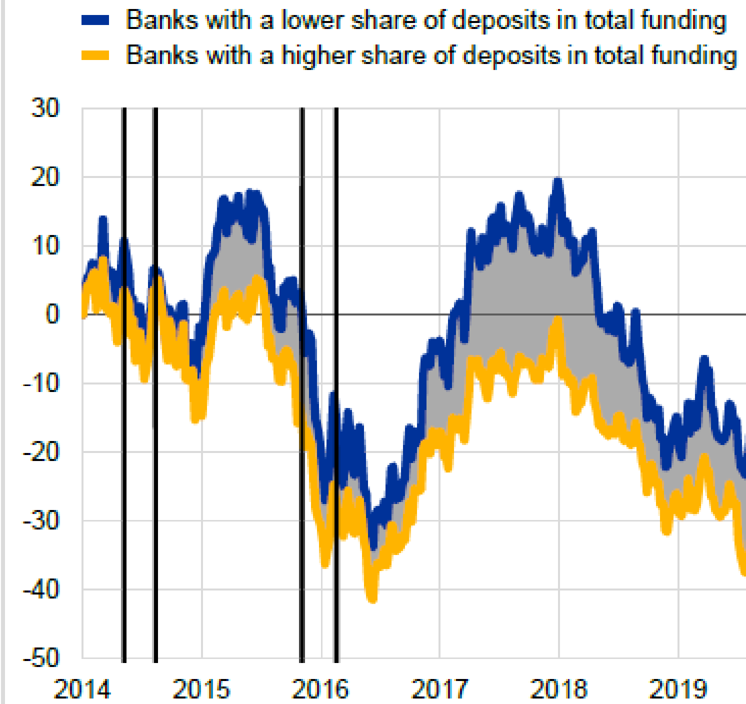
ECB forecasts for banks' return on equity in 2019-21 under the baseline scenario

(percentages, weighted average, interquartile range)



Banks' stock returns by bank funding structure

(percentages)



Sources: Bloomberg and ECB.
Notes: Right panel: The vertical black lines indicate the Eurosystem's interest rate decisions. The blue and yellow lines represent the total returns of portfolios built from a balanced sample of 112 traded euro area banks according to the upper and lower 50% of the deposits-to-total funding ratio, respectively. Portfolios are rebalanced monthly.

Source: ECB Financial Stability Review, November 2019, page 12

Regulation of Non-Banks

Regarding the use of margins and haircuts, the FSB recommendations to introduce minimum initial levels are quite narrow in scope and levels.

Going forward, more should be done. In a published opinion (2015), the ECB stated: “two policy instruments that potentially could reduce or limit leverage through derivatives and SFTs and the pro-cyclicality of margins and haircuts: (a) permanent minimum requirements, and (b) time-varying minimum requirements or buffers”.

Regulation should capture both derivatives and SFTs, and both centrally cleared and non-centrally cleared transactions in order to be effective to limit the build-up of leverage and reduce the procyclicality of current margin and haircut setting practices.

Policy recommendations by the FSB to address structural vulnerabilities arising from asset management activities and investment funds are too general. Remaining problems include liquidity mismatch between fund assets and redemption terms, operational risk, securities lending activities and leverage investment funds leverage, including synthetic leverage.

Leverage requirements for investment funds, already partially introduced in Europe, represent an insufficient progress. The final aim should be to extend adequate Leverage limits to a broader set of institutions

Regarding liquidity tools, authorities should be able to apply liquidity buffers, and suspension of redemptions, besides the panoply of tools at the disposal of Fund managers: redemption duration or fees, swing pricing, redemption in kind ….

The “boundary problem” and the banks’ franchise

1. **“Banks produce short-term debt, private money, as their product (Diamond and Dybvig (1983) and Gorton and Pennacchi (1990)). This short-term debt is an *inherent* feature of market economies. It is a fact that the output from real production happens at longer horizons than agents want to transact. In other words, *maturity transformation is a built-in feature of a market economy.*” (Gary Gorton 2019)**
2. ***Narrow banking* or similar approaches do not guarantee the amount of credit to finance investment and economic growth. For Schumpeter (1934) “the greater part” of funds for innovation and growth came from “ ..the creation of purchasing power by banks…The bannker is not so much primarly a middleman in the commodity “purchasing power” as a producer of this commodity”**
3. **New technologies generate new risks and do not eliminate the old ones which provide the rationale for financial regulation in the first place. Asymmetries of information, consumer protection and default externalities do not disappear with the introduction of new ways of supplying financial services. *FinTech does not provide an excuse for less regulation.***
4. **Institutions that regularly collect funds from the public and guarantee redemption at par at any time, like in deposit contracts, should be regulated like banks.**