

# From tapering to preventive policy

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*At the start of the tapering process in the United States, it is necessary to anticipate what instruments may be used in the next phase. This note makes a strong case for preventive use of macroprudential tools to complement the Basel III buffer approach along the credit cycle. Instruments need to be recalibrated to check evolving risk incentives and regulatory arbitrage. But timely tightening ahead of visible distress will meet fierce opposition and is likely to force delays. To address this tension and avoid forbearance, policymakers should initially prioritise low adjustment cost instruments, to activate upon early warnings rather than in response to shocks. These would minimise resistance, yet provide an immediate effect on risk incentives.*

*Flexible instruments may also be used to adjust the speed of transition towards more robust standards, such as future capital and stable funding norms.*

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**B**asel III aims at strengthening resilience by a classic buffer approach, essentially raising ratios to a higher standards over a transition period. Yet regulators now recognise that fixed standards alone are not suited to contain risk evolution along the cycle, as norms soon become bypassed or obsolete. Recalibrating standards early along the risk cycle is needed to counter any deterioration of risk incentive over time.

The lesson from history (Goodhart and Perotti, 2013) is that preventing a build up in risk is more efficient than focusing on how to fight the fire once it spreads. While some ex post support may be inevitable, it has long-term costs, even besides its moral hazard effect on risk incentives. Support boosts illiquid or risky asset prices by transferring value from risk averse long-term savers or tax payers to risk-taking borrowers. Ultimately it undermines long-term savings (as well as pension funds and insurers), compromising recovery and growth. It is thus irresponsible to simply wait for risk to manifest itself.

The key challenge, we believe, is that the most effective measures (such as capital ratios or stable funding) are also those that meet the greater resistance. Measures that induce more risk bearing have the strongest preventive effect, but have higher adjustment costs, and may face political opposition because of fears of reduced credit. As a result, capital standards have historically been raised only after long deliberation and lengthy transition periods.

But if the most robust standards can be adjusted only with delay, what policy may be used in a timely fashion to avoid forbearance?

We here suggest prioritising early use of low adjustment cost instruments. As risk starts to build up, policymakers should activate instruments that offer less immediate resistance, and thus may be deployed with immediate effect. While introduced at moderate intensity, they should be recalibrated as needed along the risk cycle, to keep incentives and regulatory arbitrage in check. We also argue that flexible enforcement tools may be used for guiding the transition to stronger prudential standards.

## 1| WHAT MEASURES HAVE LOW ADJUSTMENT COSTS?

What tools may have a lower cost, when introduced at an early stage?

- Preannounced measures distributed over time, such as a countercyclical buffer policy.
- Closely related to the first are preventive conversions of pre-issued capital instruments (contingent convertible debt, or CoCo bonds). A preventive effect requires going-concern conversion, delivering equity capital precisely when leverage become excessive and incentives start to deteriorate.<sup>1</sup> A high conversion trigger implies that they are costlier at issuance, but costless upon timely conversion. They are natural microprudential instruments, but in some proposals their conversion is triggered by a macroprudential event.
- Most important are novel tools that rely on price effects rather than on quantitative norms, such as prudential charges. These are natural macroprudential tools to target risk externalities, aligning private and social costs.

We discuss next the countercyclical buffer, and more extensively the use of prudential charges.<sup>2</sup>

## 2| MACROPRUDENTIAL TOOLS IN EUROPEAN LEGISLATION

European legislation (the CRD4 Directive) introduced three forms of macroprudential measures. Next to introducing liquidity charges, and enabling national adjustment to the standards, it activated a single instrument, the countercyclical capital buffer (CCB). This is a time varying capital standard that redistributes capital strengthening over time in a predictable fashion, ensuring reserves are built when market conditions are favorable.

Will the CCB be sufficient, and used robustly for adequate prevention? It is too early to tell. In Box 1 we review

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<sup>1</sup> Unlike bail-in debt, going-concern conversion has a stronger risk prevention effect, as it dilutes risk shifting incentives at a stage when a bank is still solvent, but overleveraged. A number of technical issues remain on calibration and conversion trigger for bank convertible capital. A detailed discussion can be found in the Bank for International Settlements (BIS) consultative document of July 2011.

<sup>2</sup> Some low cost adjustment tools (such as fractional liquidity buffers) achieve little risk absorption, and thus naturally have modest effects on risk incentives (Perotti and Suarez, 2011).

### Box 1

#### The Spanish experience with countercyclical provisioning

*In response to extraordinary credit growth, Spanish authorities introduced a capital adjustment program based on the prescient principle that predictable credit losses need to be provisioned even before they have to be recognised.*

*Careful empirical work (Jimenez, Ongena, Peydro and Saurina, 2013) suggests that the program did create some temporary risk absorption capacity at the beginning of the crisis. With hindsight, however, the program was too limited in scale, and the buffers proved quite insufficient. The provisioning rule was weakened under industry pressure in 2004, at a critical juncture. But even more importantly, the program did not contain excess risk creation during the boom. Buffers were set according to a fixed, linear scheme that did not recognise the increasing risk profile and leverage of borrowers. The evidence suggests that the program was circumvented as credit growth was reallocated via less constrained banks, while affected banks moved towards riskier borrowers. Yet markets were reassured by the provisioning program, which helped to ensure abundant foreign funding for the credit boom.*

*What are the lessons offered by this experience? Even a well conceived program faces the risk of inadequate scale, and the temptation of complacency. Even more critically, the lack of adjustable measures over time will undermine effectiveness and thus credibility. Future macroprudential policy has to avoid such pitfalls, adopting adjustment tools that may be easily activated and in case, escalated as required.*

the experience of the Spanish dynamic provisioning program, from which much may be learned.

### 3| CHARGES AS EASILY ADJUSTABLE TOOLS

Prudential charges are neither taxes nor fines, but Pigouvian levies targeting a time-varying externality. The classic examples are liquidity charges, aimed at compensating for individual banks' contribution to systemic liquidity risk (Perotti and Suarez, 2009; 2011).

Charges are flexible and less costly because they avoid the rigidity of forcing similar fixed requirements on all banks. Allowing banks to select the degree of adjustment (at a cost) enables self selection, so that the response

can be varied efficiently, e.g., depending on the quality of lending opportunities. As prudential charges enable a more flexible response, they impose lower costs. At the same time, they impose cash payments associated with risk exposures and thus produce an immediate incentive effect. In conclusion, they are easily activated at an early stage of leaning against the wind.

Charges also enable a more dynamic policy, as they are arguably easier to adjust than quantitative standards. Toning down charges in times of stress appears safer than weakening ratios or postponing their enactment, as they allow the maintenance of the commitment to introduce robust standards. By inducing earlier adjustment, they can help break down incentives for collective inertia, enhancing the credibility of the standards.

The critical limitation of charges is that when risk incentives are extreme, such as when banks become undercapitalised, gambling incentives are not well constrained by price tools. In this case it is best to constrain exposures directly by fixing rigid quantitative ratios (Perotti and Suarez, 2011).

### 4| FLEXIBLE CHARGES AS TRANSITIONAL TOOLS

Flexible tools should not be used as a substitute for robust standards, but may complement them. They are useful as transitional tools to complement effective but high cost measures, such as stable funding and capital ratios. Combining an active use of flexible instruments with robust medium-term standards should minimise resistance to timely adjustment along the cycle with a direct effect on risk incentives. Flexible tools can thus help maintaining commitment to robust standards, helping to fine tune the transition with attention to market conditions. In a long transition period, slow adjustment is to be expected, and may undermine the goal. Thus credible implementation requires preventing collective avoidance or inertia, since the further are intermediaries from the standards as the deadline approaches, a softening or delaying of norms becomes more likely. So, announcing tough standards without any tools to nudge banks towards compliance may undermine their credibility.

In Basel III there is no equivalent liquidity tool to the CCB. So far, only liquidity coverage ratios – LCRs

(liquidity buffers) are to be introduced over a transition period. LCRs are traditional fractional reserves for small runs; they do not contain aggregate liquidity risk. Even at the microprudential level, they have little preventive effect as their implicit cost is countercyclical (Perotti and Suarez, 2011).

## Box 2

### Liquidity charges in European legislation (CRD4)

*Art. 105:* "...competent authorities should consider the need to apply administrative penalties or other administrative measures, **including prudential charges**, the level of which broadly relates to the **disparity between the actual liquidity position of an institution and any liquidity and stable funding requirements** established at national or Union level."

*Recital 102:* "In making this assessment, competent authorities should have due regard to market conditions. Such administrative penalties or other administrative measures should apply until detailed legal acts on liquidity and stable funding requirements are implemented at Union level."

*Under the CRD4, national regulators should be empowered to charge "prudential risk surcharges" on the gap between a bank's current liquidity position and the Basel III ratios. The directive clearly recognises them as macroprudential tools, as it indicates that they should be adjusted counter-cyclically.*

*Charges are envisioned as nudging tools in the transition to liquidity and stable funding standards, ensuring steady progress in adjustment. Once the exact technical specifications of liquidity coverage ratios (LCRs) and net stable funding ratio (NSFRs) are specified in European legislation, charges may be applied to both.*

*The European Commission has already been mandated to set a standard for liquidity coverage ratios. However, charges should be ideally linked to more robust standards such as stable funding norms.<sup>1</sup> NSFRs have higher adjustment costs than LCRs, but have a more robust effect on both risk absorption and prevention. They are expected to be introduced over a longer transition. The legislation thus needs them to be defined shiftily (with minor adjustments still possible at implementation), so that charges could be set to induce a steady path of convergence (Goodhart and Perotti, 2012).*

1 Some form of liquidity charges may be used to manage restoring LCR buffers after they may be allowed to be run down to counter a run.

In contrast, the more structural stable funding norms (net stable funding ratio – NSFR) represent a major innovation and more robust standards, because of their effective impact on stability. They have been postponed, and in fact there is no clear commitment to their introduction.

A long transition to stable funding standards creates a regulatory vacuum. In addition, perceived sovereign risk in the European Union varies markedly across countries. As bank solvency is naturally linked through markets to domestic public solvency, it is obvious that the transition process to stable funding cannot be uniform across countries. Thus there is a need to manage the transition as well as to differentiate it across countries, in particular those in the Euro area where there is no national monetary flexibility. Goodhart and Perotti (2013) propose in this case to use liquidity risk charges, in the spirit of Acharya, Krishnamurthy and Perotti (2011) and Brunnermeier, Gorton and Krishnamurthy (2011). Policymakers in Europe have been for the first time in history empowered to use such measures by the CRD4 Directive (see Box 2), though to be fully activated they still require national or European definition of liquidity standards.

Because of their ease to adjust, charges enable a timely countercyclical liquidity policy. Charges can be lowered in hard times, and raised in good times for faster adjustment. They are meant to induce early adoption of standards, while giving banks the flexibility to plot their own path toward convergence. Adjusting the charges would be smoother than adjusting or postponing the ratios entirely. Surcharges can be better targeted than higher interest rates, which hit everyone and not just the gamblers.

## 5 | CONSEQUENCES OF THE CHARGES

The primary goal of surcharges is to induce a more stable funding maturity and contain contingent liquidity outflows. By creating a price wedge, they force market participants to internalise the risk externality.

Past evidence suggests that this wedge would not affect much the volume of bank credit, as it induces savers to take more term deposits. The key question is instead the cost of credit. It will be raised in good times, at most by the amount of the charges, if banks were to pass the entire cost to investors. However,

the cost and volume of credit would be more stable in bad times, for two reasons. First, banks will suffer less rapid outflows and would need to deleverage less, or less rapidly. Second, countercyclical charges will be lowered in times of credit crunch. On average, it may have little effect. Critically, since the crisis there is a consensus that volatile credit access is very costly for businesses and taxpayers.

## 6 | OTHER POSSIBLE PRUDENTIAL CHARGES

In principle, charges may be adopted to target funding and speculative strategies that create external effects. Shin (2010) calls for measures, including charges, to target non-core funding. His contribution has been appreciated among emerging countries, long plagued by unstable capital flows. Prudential charges based on stable funding norms have parallels with some forms of capital controls adopted in emerging countries. Influential IMF reports (Ostry *et al.* 2010; 2012) have come to recognise their beneficial effect. For instance, there is evidence in terms of a change in composition of foreign funding flows towards longer maturities.

Recently, the Korean authorities adopted a macroprudential levy on banks' non-deposit foreign currency liabilities, with increasing rates for shorter maturities. The measures appeared to be effective in reducing Korea's sensitivity to global liquidity conditions.

Charges have also been proposed both to target unstable funding sources such as short-term wholesale and foreign funding, and the build up in asset encumbrances caused by the increasing use of secured financial credit. For a review of the liquidity risk associated with the safe harbour privileges enjoyed by repo and derivative contracts, see Duffie and Skeel (2012), and Perotti (2010, 2013).

## 7 | COORDINATION OF CHARGES IN THE EUROPEAN BANKING AREA

International coordination of rate-setting is desirable, but this does not imply they should be set at equal levels in all countries. A level playing field requires that riskier financial systems require higher charges, else competition is distorted.

While monetary union requires a common financial market, national rules are still needed to maintain its integrity. Country-based charges would enable some flexibility in the Euro area, allowing marginal bank funding rates to vary across countries. It would have been desirable in 2005-2007 for Spain and Ireland to have had higher charges than Germany, where there was no foreign credit-fuelled real estate bubble. Such flexibility would actually reinforce cohesion in the Euro area, reducing the rigidity imposed by the single monetary area. At present, there are no clear tools for this purpose: European countries run different prudential liquidity frameworks.

A final benefit of liquidity risk charges is that besides targeting risk creation, they contribute revenues for national financial stability funds.

## 8 | CONCLUSIONS

Microprudential standards improve risk choices and resilience at the level of individual intermediaries. In contrast, macroprudential policy needs to target propagation risk, aiming at preventing and containing crises. Regulators now recognise that fixed prudential standards are not suited to contain risk evolution along the cycle, as norms soon become bypassed or obsolete. Recalibrating standards along the credit cycle allows the regulator to counter any deterioration of risk incentives over time. Timely macroprudential intervention is thus key to risk prevention. As Andrew Crockett (2000) said early on: *"The received wisdom is that risk increases in recessions and falls in booms. In contrast, it may be more helpful to think of risk as increasing during upswings, as financial imbalances build up, and materialising in recessions."*

We have proposed a strategy on how to select and adjust instruments over the credit cycle. While there is some experience in relaxing standards in times of distress, the real challenge is how to design a preventive strategy in normal times. But forcing more risk absorption in a boom phase implies direct costs and slows down credit, leading to strong resistance. Thus prevention cannot credibly rely on rapidly escalating tough measures. We suggest defining robust standards for the medium-term, and guiding their implementation by nudging intermediaries with flexible tools. These must be easy to deploy and escalate rapidly, as well as easy to tone down without undermining the long-term targets.

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