Is Bank Regulation Supporting or Hindering the Recovery in Europe?

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Outline

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Part 1

A creditless recovery?

A creditless recovery?

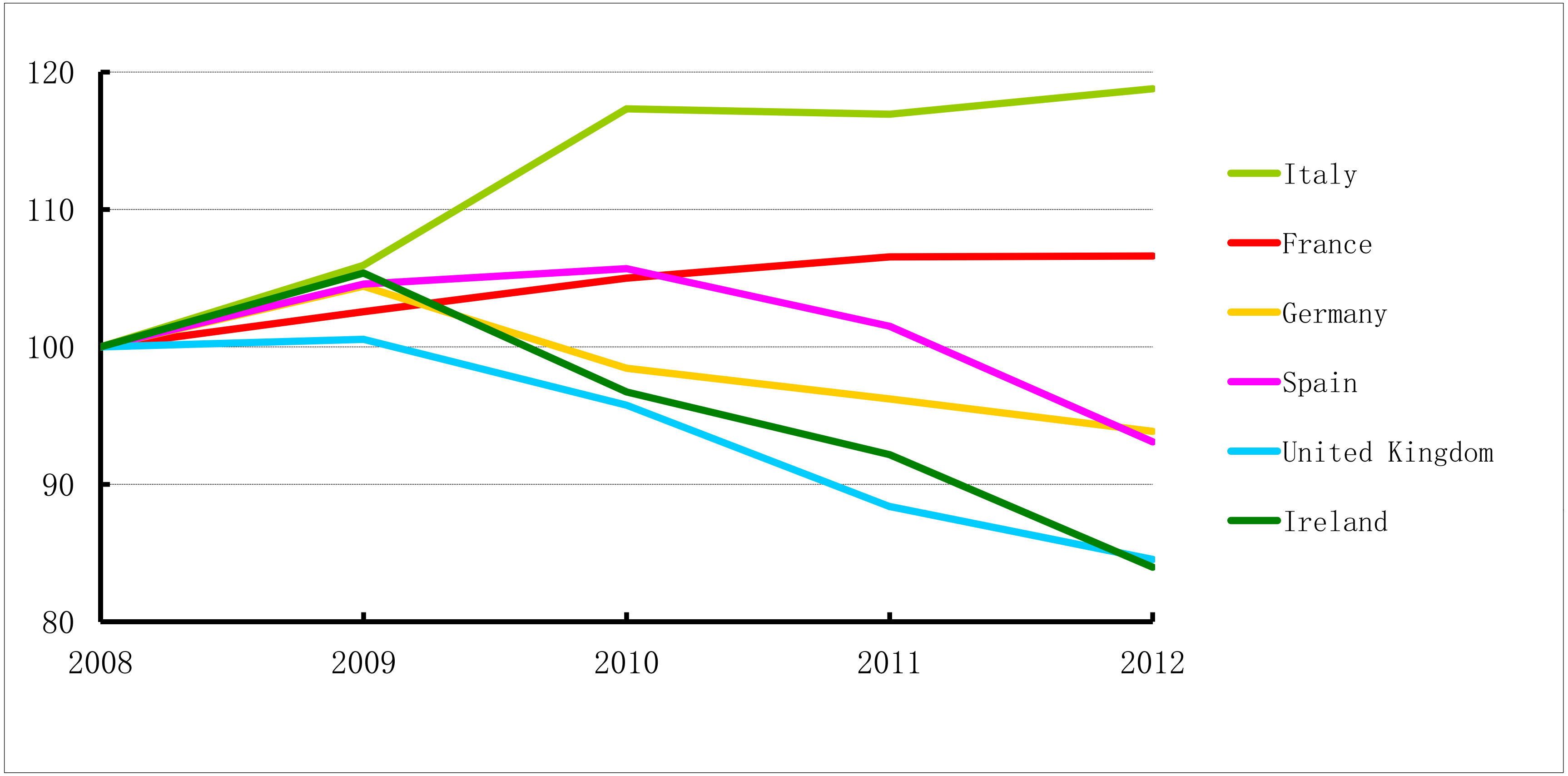
"The other obstacle to a return to normality is our banking system where, despite the generous provision of liquidity and funding from the State, lending remains lacklustre."

Mervyn King, 19 June 2013

"Reviving credit growth is one of the most pressing challenges for the euro area today."

Benoît Cœuré, 11 July 2013

Credit to GDP for a sample of countries



Domestic credit to private sector (% of GDP)

Supply of bank credit to firms

Ifo World Economic Survey, August 2013

Scale from 9 (not constrained) to 1 (strongly constrained)

Germany	7.0	← Unconstrained
France	5.9	← Moderately constrained
United Kingdom	3.2	
Italy	2.8	
Ireland	2.7	← Strongly constrained
Spain	1.7	

The credit conundrum

- Is recent credit behavior driven by supply or demand factors?
- Both factors are likely to be part of the explanation

  → Policymakers and regulators tend to stress demand factors
- Empirical evidence is likely to be inconclusive

  → Too short samples for meaningful identification
- What could be done?

  → Use a little bit of theory and a little bit of common sense

Part 2

A little bit of theory

The procyclicality problem

"In a downturn, when a bank's capital is likely to be eroded by loan losses, its existing borrowers will be downgraded forcing the bank to hold *more* capital against its current loan portfolio To the extent that it is difficult or costly for the bank to raise fresh external capital in bad times, it will be forced to cut back on its lending activity, thereby **contributing to a worsening of the initial downturn**."

Kashyap and Stein (2004)

A simple model of optimal regulation

- Repullo (2013): “Cyclical adjustment of capital requirements”
- Optimal response to negative shock to bank capital

  → Lower capital requirements
- Trade-off

  → Adjustment implies riskier banks

  → Adjustment prevents credit crunch

Model setup

- Continuum of banks with different risk types
- Unit investment that may be funded with deposits and capital

  → Infinitely elastic supply of uninsured deposits

  → Fixed aggregate supply of bank capital

  → Endogenous cost of capital
- Moral hazard problem in choice of risk

  → Role of bank capital

Why regulation?

- Social cost of bank failure
- Risk-neutral regulator

  → Maximizes social welfare

  → Subject to same informational constraints as market

  → Use capital requirements to influence banks’ risk-taking

Optimal capital requirements (i)

- Properties of optimal capital requirements

  → Risk-sensitive: safer banks are required less capital

  → Increasing in social cost of bank failure

  → Increasing in supply of bank capital

Optimal capital requirements (ii)

- When bank failures do not entail a social cost

  → Banks privately choose optimal amount of capital

  → Market allocation is efficient

- When bank failures entail a social cost

  → Regulation requires banks to have more capital

  → Banks will be safer

  → Aggregate investment will be lower

A negative shock to the supply of capital

- Optimal response to a negative shock to supply of capital

  → Capital requirements should be lowered

  → Banks will become riskier

  → Aggregate investment will be lower

- What happens if capital requirements are not adjusted?

  → Much higher reduction in aggregate investment

  → Lower social welfare

Part 3

A little bit of common sense

The G-20 response to the crisis (i)

"The IMF, the expanded FSF, and other regulators and bodies should develop recommendations to **mitigate procyclicality**, including the review of how valuation and leverage, bank capital, executive compensation, and provisioning practices may exacerbate cyclical trends."

Washington Summit, 15 November 2008

The G-20 response to the crisis (ii)

- "Until recovery is assured the international standard for the minimum level of capital should remain unchanged."
- "Where appropriate, capital buffers above the required minima should be allowed to decline to facilitate lending in deteriorating economic conditions."
- "Once recovery is assured, prudential regulatory standards should be strengthened."

London Summit, 2 April 2009

The G-20 response to the crisis (iii)

"We commit to developing by end-2010 internationally agreed rules to improve both the quantity and the quality of bank capital and to discourage excessive leverage.
These rules will be phased in as financial conditions improve and economic recovery is assured."

Pittsburgh Summit, 24-25 September 2009

Summing up

- The G-20 was (surprisingly) aware of the procyclicality issue
- It insisted that until recovery was assured

  → Minimum capital requirements should remain unchanged

  → Capital buffers should be allowed to decline
- It also insisted that regulatory standards should be strengthened

  → Only when economic recovery is assured

Part 4

The Basel Committee response

The Basel Committee response (i)

- The Basel Committee had a difficult task

  → Risk-sensitive regulation is (by definition) procyclical

  → A problem that was basically neglected in Basel II

  → Or dealt with a most unsuitable tool: TTC ratings

The Basel Committee response (ii)

- Addressing procyclicality in Basel III: stated objectives
  - Dampen any excess cyclicality of minimum requirements
  - Promote more forward looking provisions
  - Conserve capital to build buffers that can be used in stress
  - Protect banking sector from excess credit growth

The Basel Committee response (ii)

- Addressing procyclicality in Basel III: what do we find?
  - Dampen any excess cyclicality of minimum requirements

    → Nothing
  - Promote more forward looking provisions

    → Nothing
  - Conserve capital to build buffers that can be used in stress

    → Capital conservation buffer: good proposal
  - Protect banking sector from excess credit growth

    → Countercyclical capital buffer: poorly designed

The Basel Committee response (iii)

- What is the problem with the countercyclical capital buffer?
  - → Common reference point for taking buffer decisions
  - → Aggregate private sector credit-to-GDP gap
- Credit-to-GDP gap weakly correlated with GDP growth
  - → It may exacerbate procyclicality of regulation
  - → Repullo and Saurina (2012)

Summing up

- Basel Committee response has been disappointing
- This will probably not matter very much in the US:

> "Each appropriate Federal banking agency shall seek to make the capital standards countercyclical so that the amount of capital required to be maintained by an insured depository institution increases in times of economic expansion and decreases in times of economic contraction."
>
> *Section 616, Dodd-Frank Act*

Part 5

Enter the IMF and the EBA

Enter the IMF (i)

"There are three steps that Europe should take (…) Second, banks need urgent recapitalization. They must be strong enough to withstand the risks of sovereigns and weak growth. (…) The most efficient solution would be mandatory substantial recapitalization—seeking private resources first, but using public funds if necessary."

Christine Lagarde, 27 August 2011

Enter the IMF (ii)

- What Ms. Lagarde explicitly said
  - → European banks need more capital
  - → To withstand risks of sovereigns and weak growth
  - → Via mandatory substantial recapitalization
- What Ms. Lagarde implicitly said
  - → Capital requirements should be raised
- What Ms. Lagarde definitively did <u>not</u> say
  - → Capital buffers should decline to facilitate lending

Enter now the EBA zealots (i)

- The October 2011 “capital package” of the EBA

  → Temporary capital buffer against sovereign debt exposures

  → Core Tier 1 capital ratio set at 9%

  → Buffers to be built by June 2012

Enter now the EBA zealots (ii)

- To assess the size of the new requirements note that in Basel III
  - → Minimum common equity requirement goes from 2 to 7%
  - → Gradual adjustment completed by January 2019
- EBA's achievement
  - → Instead of 5pp in 6 years 7pp in 6 months!
  - → And of course, no proper justification, no impact study
  - → Barely a 2-page press release
  - → And an 8-page methodological note

Comments on the EBA's capital package

- I have no problem with market valuation of sovereign exposures
- But I think that the rest of the package is highly procyclical
  - → Potential for credit crunch
  - → In an environment of fiscal consolidation
  - → And monetary policy close to the zero lower bound
- Other negative side effects
  - → Upsets timetable of implementation of Basel III
  - → Heightens policy uncertainty: more precautionary buffers

Why everybody forgot G-20 roadmap? (i)

"Capital buffers above the required minima should be allowed to decline to facilitate lending in deteriorating economic conditions."

- Where were the advocates of macroprudential supervision?
- Where was the European Commission?
- Where were the IMF, the ECB, or the Bank of England?

Why everybody forgot G-20 roadmap? (ii)

- In fact they did not forget, they actively dismantled it

> "Those who argue that requiring higher levels of capital will necessarily restrict lending are wrong. The reverse is true. It is insufficient capital that restricts lending."
>
> *Mervyn King, 19 June 2013*

Part 6

Some popular misconceptions

Some popular misconceptions

- Popular justifications for higher requirements

  → Adequate response to uncertainty about banks' solvency

  → Markets were asking for higher capital

  → Excessive leverage had to be addressed

Uncertainty about banks' solvency

- Uncertainty about banks' solvency should be addressed by

  → Doing proper valuation of banks' assets

  → Reviewing computation of risk-weighted assets

- Uncertainty about banks' solvency should <u>not</u> be addressed by

  → Raising capital requirements across the board

  → Without addressing previous two issues

Markets were asking for higher capital

- If markets were asking for higher capital
  → Then let banks choose how to deal with capital markets
  → Why should regulators do the job of the markets?
- Moreover, markets typically follow the lead of regulators
  → Asking for a buffer above the minimum requirements
  → Risk of ending up with significant overshooting

Excessive leverage had to be addressed

- Excessive leverage had to be addressed

  → Sure, but we may have negative aggregate credit growth

  → Together with new credit granted to emerging firms

- If good banks stop new lending

  → The economy will go deeper into recession

  → Good banks may eventually become bad banks

  → Throw out baby with the bath water

Part 7

The role of policy uncertainty

Determinants of lending (i)

- Structure of capital requirements

$$\boxed{\frac{\text{Capital}}{\text{Risk-weighted assets}} \geq \text{Minimum}}$$

- Since banks want to operate with buffer above minimum

$$\boxed{\text{Risk-weighted assets} \leq \frac{\text{Capital}}{\text{Minimum} + \text{Buffer}}}$$

Determinants of lending (ii)

$$\text{Risk-weighted assets} \leq \frac{\text{Capital}}{\text{Minimum} + \text{Buffer}}$$

- Raising capital is not easy in a recession (debt overhang)
- Denominator has been substantially increased

  → Minimum requirements of capital have been raised

  → Policy uncertainty generates precautionary buffers

  → No wonder lending remains lacklustre

The international dimension

"Big banks must be subject to the same or very similar levels of capital, liquidity and leverage across all large markets – with the same definitions, calculations and timetables for implementation. A level playing field, based on the international standards set by the Basel Committee, is essential to ensure banks have consistent and predictable financial targets."

Bob Diamond, 16 September 2013

Part 8

Concluding remarks

Is bank regulation supporting the recovery?

- Most likely not

- It's time to go back to the principles laid by the G-20 in 2009

  → Procyclicality in regulatory policy is a first-order problem

  → Uncertainty in regulatory policy exacerbates the problem

What should be done?

- Be tough on the valuation of banks' assets (AQR)

  → No zombie banks should be allowed to operate

- Be soft on the minimum capital requirements front

  → To facilitate lending and support credit supply

- Eliminate policy uncertainty

  → Commit to implement timetable of Basel III

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