BANCO DE ESPAÑA
Eurosistema

SEACEN Course on Financial System Stability Analysis and Surveillance

Session 2: factors that affect financial stability

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1. Macroeconomic and Monetary Policies

- Close interaction between macroeconomic and financial stability (two-way relationship).
- Cycles are inherent in capitalism: bad times follow good times.
- Imbalances leading to systemic crises usually build up in expansionary periods. Financial sector pro-cyclicality.
- We focus on one-in-20-year events (example: the current crisis in Europe).
- Macroeconomic policies and imperfect institutional design can lead to financial instability:
    - In Europe, single monetary policy but essential elements for a well-functioning single currency area were missing (i.e. banking union; fiscal union).
    - Single policy rate, but very different macroeconomic fundamentals. In Spain, monetary conditions remained loose for a long time period (housing boom; credit expansion).
    - Similar problems may arise in other contexts. In Asia: competitive economies with independent monetary policy... But exchange rates may be a source of concern if misaligned with fundamentals for too long

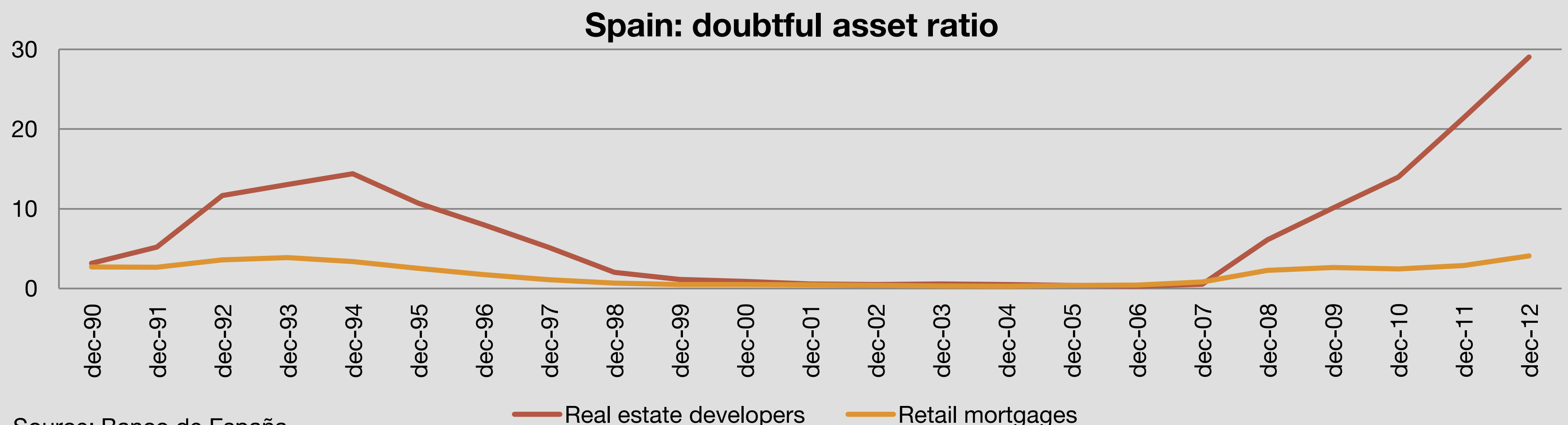
2. Financial product innovations and Shadow Banking

- Prior to the crisis: expansion of market-based financing and financial innovation.
- Increased complexity and interconnectedness.
- Development of the shadow banking system
  - Some bank-like characteristics: leverage, maturity transformation…
  - … but out of the scope of prudential regulation and supervision
- The growth of the shadow banking sector was partly driven by regulatory arbitrage
- Tighter banking sector regulation increases incentives to shift activity to the non-regulated sector
- This issue is likely to become increasingly important in the near future
- How to regulate and supervise the shadow banking sector and/or its links with the regulated sector remains a challenge (but the FSB is making progress)

3. Housing market and financial stability

- Credit expansions linked to housing booms have played a key role in several financial crises

- Credit related to real estate, Jekyll and Hyde:
  - Retail mortgages: with adequate risk management policies, a strong retail basis can support banking sector soundness. Incentives adequately aligned (especially with recourse loans)
  - Real estate developers: higher risk. It plays a key role in the build-up of bubbles (housing, commercial real estate, shopping malls)



Source: Banco de España

3. Housing market and financial stability

- What to do to minimize risks:

  - Retail mortgages: prudent risk management and beware of financial innovations (LTVs over 70-80%, interest-only mortgages, HELOCs, etc.)

  - Real estate developers: low LTVs, leverage, asset/liability maturity mismatch of real estate companies, carefully monitor asset valuation, no loan land financing.

4. SIFIs and contagion due to financial inter-linkages

- Progress in dealing with the "too-big-to-fail" problem: designation of G-SIFIs, capital requirements, FSB Key Attributes for resolution regimes, enhanced supervision, etc.
- But relevant challenges remain: effective resolution and international coordination
- Two different resolution models: multiple vs. single point of entry
- MPE especially useful for banks with standalone subsidiaries. Host supervisors have access to the relevant information and incentives are aligned by definition (but may not be adequate for investment banks).
- Key role of host supervisors:
    - SPE: they will need some guarantees from parent banks (and home supervisors)
    - MPE: higher ability to influence; must be satisfied with capital levels
- Therefore, strong need for cooperation and information sharing...
- ...but providing all host supervisors access to all supervisory data on the banking group as a whole would not be neither feasible nor practical. Increased burden could even hinder the quality of supervision

5. “Special status” institutions

- Many financial systems have financial institutions with a special status (historical reasons; national specificities)
- This type of institutions share some potential risks
  - Potential strong growth in boom phases (overcapacity; geographical expansion)
  - Fragmentation and lack of sophistication
  - Inadequate governance structures
  - Inability to obtain top quality capital in the markets
- Lessons:
  - Special status institutions may be a source of risk to financial stability, specially when they are allowed to grow and expand their activity beyond their traditional scope
  - Need for a long term perspective: it is better to undertake reforms in early stages (tackle vulnerabilities in good times, rather than in stress periods)

6. The limited scope of micro-prudential regulation and supervision

- Micro-prudential approach: focus on the soundness of individual institutions

- A macro-prudential approach is needed: focus on the financial sector as a whole (institutions, markets and infrastructures).
    - Evolution of risks over time (pro-cyclicality)
    - Analysis of risks within the financial sector: interconnections, common exposures and correlations.

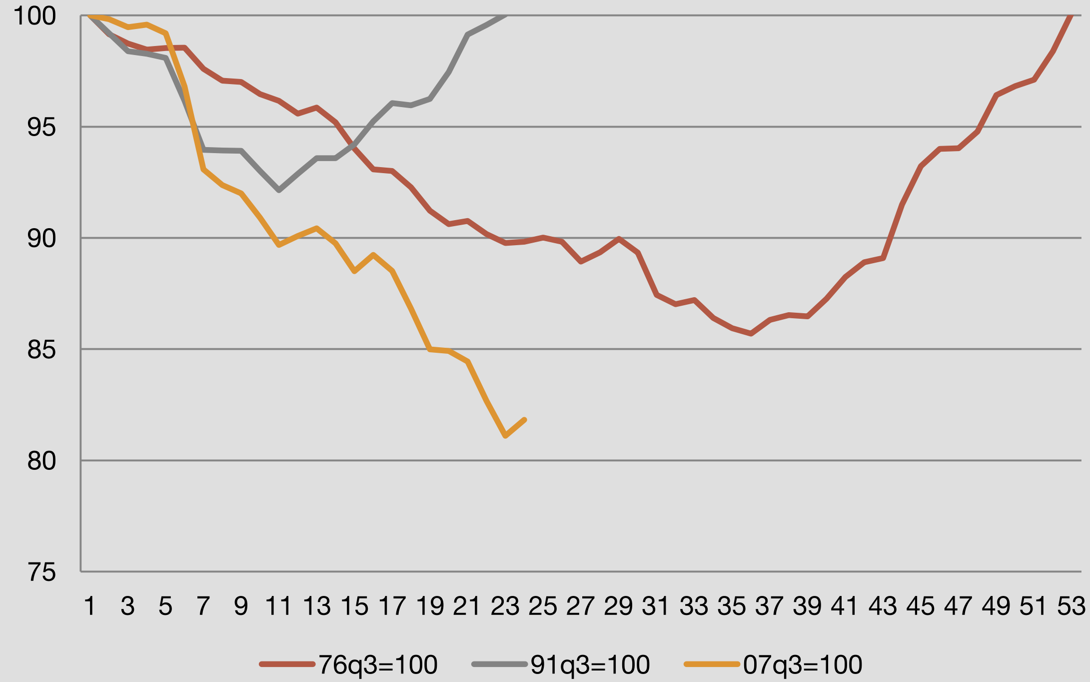
- We should be realistic: financial cycles and crises will continue to exist. The goal is to improve regulation and supervision so as to reduce their probability and minimise their impact on the economy

6. The limited scope of micro-prudential regulation and supervision

- Example: dynamic provisioning in Spain. The main historical reference available for calibration was the financial crisis in the early nineties. But the current crisis has been much longer and deeper

Spain: quarters to recover the initial level of employment

(Latest peak = 100)



Source: Herce and own elaboration, using LFS data

- Dynamic provisions were insufficient to prevent excessive credit growth during the expansion, but they were useful: provided a significant buffer and allowed to discriminate among institutions (helped better managed institutions to weather the crisis)

7. Lack of information sharing between regulators / supervisors

- The globalisation of financial activity requires enhanced cooperation and information sharing among regulators and supervisors, as well as with resolution authorities.

- The design of information sharing mechanisms depends on the banking models: branches vs. stand alone subsidiaries.

- New resolution agreements should facilitate dialogue and information sharing.

- A practical lesson of the crisis: regulators and supervisors must know their colleagues in other jurisdictions and be sure that they can turn to them if needed. Building trust is essential.

- Therefore, it is crucial to maintain and reinforce the role of international regulatory and supervisory *fora*.

8. Availability and reliability of accurate data and information

- The need for more accurate information has become evident.

- Ongoing efforts at the global level in this area (example: FSB Data Gaps Initiative). We need better and more comparable information on SIFIs, financial sector interlinkages, non-banking sector activity, derivatives, etc.

- But again, be realistic: when the crisis comes, information is never sufficient. To some extent, there will be always blackout periods in such episodes. Regulators and financial institutions must be prepared to swiftly require and provide *ad-hoc* information on specific issues in times of stress.

- Example: new requirements in Spain. Disclosure of data on real estate-related exposures and on refinanced/restructured loans (forbearance)

9. Other sources of financial instability

- Competition policies, the structure of the banking sector and its relationship with the rest of the economy can also create financial instability.

- Experience in previous Spanish financial crisis (late 1970s; early 1918s):
  - Lifting barriers to entry and fostering deregulation and competition simultaneously
  - Banking groups within commercial and industrial conglomerates (wrong incentives and excessive interlinkages).

10. Challenges of macroprudential supervision

- Communication: microprudential policy can be run inconspicuously. But macroprudential supervision will usually require a proactive communication policy (for instance, to deal with a real estate bubble). This poses important challenges in terms of public perceptions and fine tuning of the measures.
- "Type 1 vs. type 2 errors" and incentives for a proactive macroprudential policy:
    - Type 1 error: miss a systemic crisis
    - Type 2 error: misidentification of systemic risk and implement measures that are not needed
    - By design, macroprudential authorities will try to minimize type 1 errors at the expense of increasing type 2 errors, leading to activism and to efficiency costs for the financial system.
    - Two challenges:
        - Credibility ("Peter and the wolf")
        - Risk of overburden. The withdrawal of measures should be as quick as their implementation once they are no longer needed.

11. Conclusions

- The macroprudential approach is at the core of the new paradigm of financial supervision.
- However, significant challenges remain:
    - The occurrence of crisis can be taken for granted…
    - … but their timing and intensity is hard to predict
    - Ongoing improvements in data availability. But even with wealth of data, the analysis of interlinkages remains difficult.
    - Need to define and calibrate new instruments (LTVs, etc.)
    - Need for a strong institutional setting for the conduct of macroprudential policies

Thank you for your attention