Back to the (macroprudential) future: Reflections and questions on macroprudential policy

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Keynote speech at the HKMA-BIS joint conference on "Future-proof supervision for an innovative banking world"
Hong Kong SAR, 24 March 2023

Introduction

Good morning, and thank you for inviting me to speak at this joint HKMA-BIS joint conference celebrating the HKMA's 30th anniversary.

As the Chair of the Basel Committee, I should mention two more anniversaries that are worth commemorating today. First, the Committee has met in person in Hong Kong over the last couple of days. It has been 10 years since the Committee last met in Hong Kong. I speak on behalf of all Committee members in saying that it is a pleasure to be back here, and I thank the HKMA for its hospitality this week.

Second, it has been 14 years since the HKMA joined the Committee as a member. Since 2009, the HKMA has always been a highly valued member, not least for its long-standing commitment to cross-border cooperation and its constructive contributions, including chairing some of the key Committee groups. These contributions have been critical in supporting the work of the Committee and in seeing through our major post-Great Financial Crisis (GFC) regulatory and supervisory reforms. The Committee has benefited in many ways from the HKMA's perspectives and experiences across a wide range of issues during this period, and am sure it will continue to do so in the future.

But let me come back to the 30th anniversary milestone and revisit the work of the Committee in the year of the HKMA's establishment. In 1993, the Basel Committee had only recently finalised the Basel I framework, and was issuing consultation papers on the prudential treatment for capitalising against market risk and measuring interest rate risk.[1] In some respects, certain elements of these consultations sowed the seeds for the development of the Basel II framework later in the 1990s.

Yet despite the passing of 30 years, some of the Committee's supervisory concerns in 1993 sound familiar. Going back to the consultation papers issued at that time, the Committee

[1] BCBS (1993a, 1993b, 1993c).

noted that market risks to banks were growing as a result of "the rapid development of financial markets".[2] It went on to stress that interest rate risk is "a significant risk which banks and their supervisors need to monitor carefully", and that "a change in interest rates might adversely affect a bank's financial condition through its effect on all interest-related assets, liabilities and off-balance-sheet items".[3] Clearly, these messages continue to hold today, as we have seen from recent events.

Recent events have further highlighted the importance of a resilient global banking system underpinned by effective bank governance and risk management practices, robust regulatory standards, and strong supervision supported by proactive cross-border cooperation. Since the Great Financial Crisis, the Basel III reforms have helped the global banking system absorb different shocks and continue to lend to creditworthy households and businesses.

The risks of high inflation, lower growth and geopolitical tensions are posing risk management challenges to banks. Years of unprecedentedly low interest rates underpinned the build-up of leverage across household and corporate sectors. As central banks raise interest rates to combat inflation, borrowers are now facing sharply rising debt service burdens. A broad-based repricing in asset markets could also expose banks to additional risks and new risk management challenges.

Banks and supervisors must therefore be vigilant to the evolving outlook to ensure that the global banking system is resilient. The Committee will continue to closely monitor bank and market developments and assess the financial stability risks of higher interest rates to the global banking system.

In addition, the Committee agreed to take stock of the regulatory and supervisory implications stemming from recent events, with a view to learn lessons.

So the theme of our conference today – future-proofing supervision for an innovative banking world– is a highly topical one. We have witnessed profound changes to the global banking system as a result of ongoing structural and disruptive factors, geopolitical developments and conjunctural risks. Indeed, many of these issues were discussed by the Committee earlier this week and summarised in the press release published yesterday.[4] But there are also perennial challenges and risks faced by banks and supervisors. So it is right to take a step back and review our supervisory and regulatory philosophy in the light of such changes.

Today, I will focus the rest of my remarks on one area which has witnessed profound transformation, namely, the use of macroprudential regulation and supervision.

[2] Ibid.

[3] Ibid.

[4] Press release: Basel Committee to review recent market developments, advances work on climate-related financial risks, and reviews Basel Core Principles (BCBS (2023)).

The return of the Mac(ropru)

At its most basic, macroprudential regulation and supervision seeks to safeguard financial stability by applying (primarily) prudential measures through a system-wide perspective on the distribution and evolution of risks across two main dimensions:

- The cross-sectional distribution of risks resulting from interconnections, common exposures and collective behavioural responses by financial institutions at any given point in time.

- The evolution and amplification of risks at an aggregate level over time resulting from the inherent procyclical dynamics of financial institutions and markets through the financial cycle.[5]

Economic historians may note that macroprudential policy is not a post-GFC innovation. Peter Cooke, one of my esteemed predecessors as Chair of the Committee, first mentioned the term at a Committee meeting in June 1979, where he noted that "the Committee had a justifiable concern with macroprudential problems" and that "it was the link between those and macroeconomic ones which formed the boundary of the Committee's interest".[6] The BIS then used the term publicly in a report in 1986, where it defined it as a policy that promotes "the safety and soundness of the broad financial system and payments mechanism".[7]

The pre-GFC macroprudential world was not just limited to conceptual discussions. Many jurisdictions – including several in the Asia-Pacific region – had in effect applied macroprudential measures years before the GFC.[8] For example, Hong Kong applied bank exposure limits to the property market as far back as 1994, Malaysia increased risk weights for certain housing loans in 2005, and India increase provisioning requirements in the same year. Macroprudential policy is therefore, in many ways, an old idea whose time has come round again.[9]

But the GFC also painfully highlighted the limited systematic use of macroprudential regulation and supervision. Fuelled by very high levels of leverage and maturity transformation, a web of opaque and highly interconnected chains between financial entities was left largely untouched by regulation in the run-up to the crisis. As risks started to crystallise, the sharp retrenchment of key financial services by banks and other financial entities, in part a necessary process to unwind the excessive leverage in the system, exacerbated economic conditions and hindered the subsequent recovery (Graph 1). A fundamental revamp of regulation and supervision was needed.[10]

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[5] See, for example, Borio (2003) for a deeper elaboration.

[6] Clement (2010).

[7] BIS (1986).

[8] Borio and Shim (2007).

[9] Borio (2009).

[10] BCBS (2015).

Thankfully, the GFC did not go to waste, as it prompted a breakthrough in the use and application of the macroprudential perspective.[11] Jurisdictions around the world adopted financial stability mandates, deploying an increasing number of macroprudential measures over time (Graph 2).[12] The term "macroprudential" itself has now been comfortably adopted into the vernacular of central banks and supervisory authorities (Graph 3).

The Committee itself was quick in applying a more rigorous macroprudential regulatory and supervisory overlay post-GFC. It set up a high-level Macroprudential Supervision Group to develop approaches to promote the practical implementation of macroprudential supervision for the banking sector. The Committee's broad work on macroprudential issues comprised three main dimensions.

First, the introduction of regulatory capital and liquidity buffers. These buffers provide an additional layer of shock-absorbing capacity over and above minimum requirements. They are intended to be used by banks in times of stress to absorb losses and meet liquidity demands in an orderly way, while continuing to lend to creditworthy households and businesses. They include the following:

- The capital conservation buffer, which provides banks with an additional layer of resilience and capacity to absorb losses in times of stress while providing key services to the real economy.

- Buffers for globally systemically important banks (G-SIBs) and domestic systemically important banks (D-SIBs), which add a further layer of resilience for banks with a large systemic footprint. The Committee has been conducting an annual G-SIB assessment exercise since 2011 and many of our members have also applied the D-SIB framework.

- A countercyclical capital buffer, which can vary over time and aims to protect the banking system as a whole against losses resulting from the build-up of systemic risk.

- A buffer of high-quality liquid assets to help meet potential liquidity outflows in times of stress, as stipulated in the Liquidity Coverage Ratio (LCR).

Second, the development of a suite of regulatory and supervisory metrics. In addition to the risk-weighted ratio, the Basel III framework also includes a leverage ratio, large exposure limits and two liquidity standards (the LCR and the Net Stable Funding Ratio). And supervisory stress testing plays an increasingly important role across a number of jurisdictions.

The move towards a "multiple metrics" framework recognises that each individual regulatory/supervisory measure has strengths and weaknesses and cannot be relied on in

[11] Knot (2022).

[12] BIS (2018).

isolation.[13] The multiple metrics framework is more robust to arbitrage and erosion over time, as each measure offsets the shortcomings and adverse incentives of the others. For example, the leverage ratio provides an absolute cap on leverage, but, by itself, could incentivise banks to increase their holdings of higher-risk assets. The risk-weighted framework compensates for this as it constrains banks that materially increase their risk profile without any commensurate regulatory capital to fund their balance sheets. And the liquidity standards require banks to maintain a prudent buffer of high-quality liquid assets and restrict the degree of maturity mismatch. The design of the Basel III framework was in itself based on a system-wide perspective on these metrics.[14]

Third, the Committee now pursues a more rigorous and forward-looking approach to its supervisory initiatives. This includes our regular exchanges of views of emerging risks and vulnerabilities and our ongoing work in promoting strong supervision through the issuance of guidelines, sound practices and supervisory newsletters. We approach this work through both a macro- and microprudential lens.

Looking back: initial Basel III macroprudential lessons learned

So, what has been our experience to date with regard to the macroprudential elements of Basel III? The Committee has been evaluating the impact and efficacy of these reforms, drawing on a wide range of empirical evidence and consulting with external stakeholders.[15] We have published three reports to date.[16] I could not do them justice in a single speech, so let me just highlight a few high-level takeaways.

The overarching story is a generally encouraging, albeit incomplete, one.

Starting with the impact of Basel III macroprudential reforms on banks' resilience, the Committee found that the introduction of these reforms was associated with a decline in various measures of systemic risk.[17] Starting with the G-SIB framework, we found that G-SIBs reduced the share of complex and high-risk assets of their balance sheets in response to their G-SIB designation by a greater proportion relative to non-G-SIBs. They also issued more capital than non-G-SIBs. Importantly, this behaviour did not come at the cost of a significant (negative) change in their lending behaviour. More broadly, our evaluation found that banks' capital strength can help dampen negative feedback effects among banks under stress, thereby reducing the probability of a stress resulting from the failure or distress of a single bank. Such outcomes are fully aligned with the objectives of the G-SIB framework.

[13] Ingves (2016).

[14] Borio et al (2020).

[15] Hernández de Cos (2019, 2021, 2022).

[16] BCBS (2021, 2022b, 2022e).

[17] These include ΔCoVaR, Exposure-ΔCoVaR, Marginal Expected Shortfall and SRISK.