Banks / Financial Regulation

Procyclical financial regulation: what can be done?

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The Covid crisis brought about an impressive activism on the part of financial regulators. Measures taken to offset the impact of the pandemic included (i) encouraging forbearance and avoiding automaticity in nonperforming loans (NPLs) accounting and provisions, (ii) allowing the use of capital and liquidity buffers, (iii) reducing the supervisory, operational and reporting burden, (iv) delaying the entry into force of more stringent requirements while (v) bringing forward more lenient ones and (vi) ensuring the continuity in the provision of critical functions. Governments provided guarantees to loans to companies and individuals affected by the pandemic, which enjoyed a better regulatory treatment.

These measures allowed maintaining credit lines in most countries and were very much in line with demands from the banking industry. The wave of stimulus measures was in contrast with the tone of the regulatory reform carried out since the 2008 crisis, aimed at safeguarding financial stability and strengthening solvency.

Why did financial regulation require such a radical reversal? The short answer is that it is so sensitive to the deterioration of the economy that a sudden downturn, in the absence of compensating measures, would entail a huge credit crunch that would in its turn aggravate further the crisis, thus generating a vicious contractionary spiral. The procyclicality of financial regulation, which was identified as a key weakness at the time of the 2008 global financial crisis, not only has not been solved but apparently has been even reinforced as a result of the reforms.

It is important to clarify upfront that risk is cyclical and therefore some of this procyclicality is inherent to the financial sector. This has been analyzed in the literature for a long time (for instance in Minsky's financial instability hypothesis). The key question here is to what extent financial regulation can attenuate this procyclicality or at least be neutral. In this regard it is important to consider which constraint is binding in each cyclical situation: financial regulation or market discipline. In the boom phase markets tend to relax to the point of being even myopic, which requires the authorities to be particularly vigilant. This has not always been the case: there is some evidence that in particular monetary policy has reacted to falls in asset prices in the bad times but not to increases in them in the good times (the so called Greenspan's put).

In the bust, however, markets are more demanding, which means that, even though regulators would tend to be more lenient, the binding constraint is elsewhere, and regulatory action may be like "pushing on a string". There are situations in which the authorities are powerless in stimulating credit even though they use all their monetary policy firepower (including negative interest rates, Quantitative Easing and ample liquidity), on top of micro and macroprudential policies.

If policies tend to be too lenient in the boom and markets tend to be too harsh in the bust, what we need is tighter policies in the good times and more forward-looking markets in the bad times. Macroprudential policies and expected loss accounting (to the extent that financial statements are a key input to market valuations) have been introduced to address both objectives, the former mostly for the boom and the latter mostly for the bust. But their results have been uneven:

- Many countries adopted different modalities of macroprudential policies in recent years, in line with recommendations from international bodies and standard setters like the FSB or the Basel Committee. The experience so far is limited, but points to a higher effectiveness in emerging markets, where they have been often accompanied by capital controls, than in developed markets, where macroprudential policies are far from a panacea.
- Expected loss accounting is based on the correct idea that most lending mistakes are made in the good times, but only transpire in the bad times. The International Financial Reporting Standard IFRS-9 implied a move from realized losses to expected losses in NPLs that was intended to smooth procyclicality. The idea was that, if NPLs were based on a longer horizon, they would be less dependent on contemporary cyclical conditions, and would rather reflect structural macroeconomic conditions not affected by the cycle. Paradoxically, the way IFRS-9 was designed implied an increase of procyclicality, due to the move of significantly deteriorating loans from 1 year horizon to lifetime horizon, which implies that provisions are multiplied exponentially. Since this move tends to happen in the downturn, the pattern of provisions is more procyclical than under the old accounting approach.

A related discussion is which instrument is preferable to deal with the cycle, anti-cyclical capital buffers or dynamic provisions. In theory it basically depends on our ability to calibrate the cycle ex ante. If the models had perfect foresight, the anticyclical policies would rely on expected losses, and provisions would be preferable to capital. If, on the contrary, our ability to forecast the cycle is low, unexpected losses would dominate, and capital would be preferable to provisions. The regulatory reform adopted by global standard setters seemed to adopt the latter view, which was reflected on a preference for countercyclical capital buffers instead of dynamic provisions. The sudden nature of the Covid crisis, impossible to forecast with any model, certainly reaffirms a healthy skepticism on our capacity to calibrate the cycle, but does not exclude that prudential tools can be based on rules.

Indeed, all the previous discussion is related to the “rules vs discretion” debate. To the extent that policies face time consistency problems, react asymmetrically along the cycle and are constrained by markets that are procyclical, a rules-based mechanism seems preferable to a purely discretionary one. In this regard, dynamic provisions may be superior to counter-cyclical buffers, since it is easier for provisions to be rules-based. The choice between dynamic provisions and capital buffers depends however on a number of other features, and in any case they are not mutually exclusive.

Another area of further reforms is the composition of capital buffers. One lesson of the Covid crisis is the need for a bigger role of the countercyclical capital buffer as compared to other, more structural buffers: the capital conservation buffer, the systemic risk buffer, the global (or local) systemically important institutions buffer… A positive countercyclical buffer in a neutral cyclical position, compensated with lower structural buffers so as to avoid an overall increase in total capital requirements, would allow for a swift reaction to a sudden shock like the Covid crisis.

To sum up, the objective of making financial regulation less procyclical is proving elusive. Some measures have been taken, but their effectiveness is so far unclear. The authorities often face a time consistency problem, and the pressure of the markets complicates the implementation of policies. A more rules-based approach, in which the procyclicality of market discipline is in-built, together with a recognition of our very limited capacity to calibrate the cycle ex ante seems advisable. And the relation between countercyclical capital buffers and dynamic provisions under expected loss accounting is an area that deserves further research.

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