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INSTRUMENTS OF MACROPRUDENTIAL POLICY

A response by the Building Societies Association

Introduction

1. The Building Societies Association (BSA) represents mutual lenders and deposit takers in the UK including all 47 building societies. Mutual lenders and deposit takers have total assets of over £375 billion and, together with their subsidiaries, hold residential mortgages of over £235 billion, 19% of the total outstanding in the UK. They hold more than £250 billion of retail deposits, accounting for 22% of all such deposits in the UK. They employ approximately 50,000 full and part-time staff and operate through approximately 2,000 branches.

2. The BSA recognises that the FPC needs its own policy instruments to be able to act to mitigate risks to financial stability. However, BSA members have concerns relating to some of the macroprudential instruments proposed in the Discussion Paper, and these are outlined below. Some more general points about the criteria for judging instruments are also raised, recommending that the impact on firms with different business models is more explicitly considered, and the interaction of any instruments with ongoing domestic and international regulatory developments is also analysed more thoroughly.

Macroprudential instruments

3. Firstly, limits on the terms and conditions of certain transactions, notably limits on loan-to-value (LTV) and loan-to-income (LTI) ratios, would be undesirable because they would not sufficiently take individual circumstances into account. The Discussion Paper claims that such restrictions would directly limit risky lending, and enhance resilience to risks from real estate. However, restricting products with these features could have too great a cost if they bluntly penalise consumers who are genuinely able to repay these loans and who pose little risk to financial stability. Alternatively, LTV and LTI limits might be ineffective because they could lead to perverse incentives for consumers who might use other secured or unsecured borrowing to purchase property, increasing their total debt while satisfying any restrictions on mortgage terms. Furthermore, the use of these tools would have to be carefully calibrated with existing conduct-of-business regulations. Raising the risk weights applied to higher LTV or LTI loans would not mean that these loans were prohibited, but the amount supplied would be reduced, and could therefore still lead to the above problems. Like sectoral capital requirements, this could also lead to risk shifting to other types of lending.

4. In the Mortgage Market Review, while acknowledging that macroprudential concerns were out of scope of that review, the FSA noted that high LTVs did not appear to have played a critical role in falling credit standards and over-rapid credit growth, and while there was a correlation between high LTVs and defaults, other characteristics of the loan (for example whether income had been self-certified) were more powerful in explaining defaults[1]. Conversely, the FSA found that relaxation of LTI criteria did add to credit growth, but were not closely linked to default rates. These findings would suggest that supervisory regulation may be more effective in addressing risks to the system from the relaxation of mortgage terms than blanket restrictions on LTV or LTI ratios.

[1] http://www.fsa.gov.uk/pubs/discussion/dp09_03.pdf

5. The use of a maximum non-risk weighted leverage ratio (of total assets to bank equity) could have a detrimental effect on firms whose balance sheets are predominantly made up of low-risk assets (and will not identify where funding exhibits short maturities, is secured on poor quality collateral, or is from unstable sources). For example, firms where the majority of assets are low risk residential mortgages, and which are otherwise well capitalised, might find their activities unreasonably constrained by changes to the maximum leverage ratio. Such assets have exhibited low levels of arrears, and across the last decade annual write-offs averaged 0.02% of average mortgage balances, and peaked in 2009 at 0.08%[2].

6. Leverage ratios fail to distinguish between short and long term funding, or between stable and unstable funding sources, and thereby fail to recognise high liquidity risk. Penalising firms that have a low risk appetite is not conducive to reducing risks to financial stability; it may cause these firms to react in a number of ways including moving to higher risk business, reducing the amount of low risk lending they do, or seeking to extract more profit from customers.

7. Another potential tool that could be extremely costly for firms is that of information disclosure, and we would urge the FPC to consider for all additional disclosure requirements the costs to firms of collating and analysing this data, particularly if it is unusual, changes frequently or is unlikely to be collected by firms already, and to assess these costs against the benefits of the disclosure. EU Capital Requirements Regulation is also due to codify disclosure requirements with a set of mandatory Pillar 3 disclosures, and a general prohibition on regulators disclosing supervisory information. It might therefore be difficult for the UK to require further disclosure beyond this, though the PRA has already indicated it might wish to publish some of this information.

8. More generally, the objective of market discipline should be balanced against the risk of undermining confidence. It is important that the FPC publicly explains the purpose of any disclosure, and what the information to be disclosed means. If this purpose is not properly explained there is a risk that the information is misinterpreted, which could affect confidence in ways that are unwarranted or unhelpful. This would be particularly true at a time of market stress when additional disclosures could signal and crystallise any problem, whether real or merely perceived. There is therefore a risk that additional ad hoc disclosures at times of market stress could be pro-cyclical, which might not be the case with set through-the-cycle disclosure requirements.

Proportionality and the effects on different business models

9. An additional criterion that all potential macroprudential instruments should be judged on is whether they have an unduly disproportionate effect on certain types of firm. Different types of firm pose different degrees of risk to the system, and blanket usage of macroprudential tools could harm low risk firms as much, or more than, more risky firms. This is the case, for example, in the use of a non risk-adjusted leverage ratio. Indeed, any macroprudential instruments that involve changes to the amount of capital required highlight the importance of the development of a core equity instrument consistent with mutual models of ownership. This would be necessary for mutuals to respond rapidly to varying capital requirements by raising capital rather than by shrinking their assets. Without such instruments, mutuals would be at a competitive disadvantage to other firms should they have to raise capital quickly.

10. Another key factor could be firm size. It might be worthwhile applying a *de minimus* exemption on the application of some instruments. For example, the burden on firms of requiring additional ad hoc disclosures could be particularly significant at smaller firms, which individually are likely to be of little importance to the stability of the financial system as a whole. Such requirements could be focussed on the largest firms and still be effective.

Concurrent regulatory changes

[2] Based on Bank of England data: Annual UK MFI write-offs of lending secured on dwellings as a proportion of average amount outstanding of secured lending.

11. Against a regulatory background that is still developing across many of the areas where these potential macroprudential instruments will operate, it is difficult to estimate precisely what the additional effect of the tools will be. Judgement of the macroprudential instruments should therefore consider not only the independence of the instruments to each other, but also to developments in conduct of business and microprudential regulation.

12. Furthermore, many of the regulatory changes that coincide with some of these potential instruments are being decided by European regulation under maximum harmonisation, so domestic discretion cannot be applied to the regulations. For example, the maximum harmonisation approach under the EU Capital Requirements Regulations (CRR) may limit the ability to set higher capital requirements domestically, or to advance publication of leverage ratios prior to the timetable set in the final CRR.

Other considerations

13. It would be beneficial if the Bank could conduct some modelling using historical data on the effectiveness of different tools, whether in isolation or in combination, to assess the impact of the instruments on the potential sources of systemic risk if they had been used in the build up to the recent crisis[3].

14. The macroprudential tools being considered will have a significant impact on firms within the financial system. Clear and transparent communication of how the FPC plans to use each tool, and under what circumstances, is essential to enable firms to plan for the tools being used. It would probably be beneficial to have further consultation once the FPC has conducted more analysis and decided upon the most useful macroprudential instruments.

[3] For example, along the lines of the recent bank working paper by Aiyar, Calomiris and Wieladek: http://www.bankofengland.co.uk/publications/workingpapers/wp445.pdf