

Macroprudential Supervision: Proceed with Caution

BY JOHN A. WEINBERG

One of the most widely accepted conclusions drawn by those examining the financial crisis and its effects is that financial regulation was inadequate in a number of ways. In particular, many argue that focusing on the conditions of individual institutions led regulators to overlook important macroeconomic or systemic aspects to the evolution of risks in the financial system. As a result, discussions of ways to improve regulation in the legislative process have focused on supplementing the current *microprudential* approach of supervision of individual institutions with a *macroprudential* approach to system-wide supervision.

A more macroprudential approach might mean many things. For instance, it might mean greater direct attention to the linkages among financial firms, especially the largest firms, in order to identify potential sources of spillovers of distress from one firm to its counterparties. Macroprudential supervision might also involve looking for concentrations of exposures by leveraged financial intermediaries to large aggregate risks in order to quantify how large a macroeconomic shock would be required to seriously compromise the capital buffer of the financial system as a whole. Broadly speaking, this type of exercise reflects the spirit of stress-testing, like that which was conducted for the largest financial firms in the winter and spring of 2009.

In addition to questions of measurement, macroprudential supervision raises questions of the appropriate regulatory response to indicators of risk at the system-wide level. One ingredient of macroprudential regulatory policy that has been suggested is to make some of the regulatory levers depend on certain macroeconomic conditions. For instance, some proposals call for adding a “countercyclical” component to bank capital requirements, so that required capital buffers for some firms would be greater at times when credit is expanding rapidly. Since credit generally tends to rise and fall with overall economic activity, this amounts to making bank regulation a macroeconomic policy tool.

Countercyclical bank regulation would create a new set of challenges for policymakers. Adjusting regulatory constraints on financial institutions with the rise and fall of credit flows in the economy creates a regime in which policy essentially leans against cycles in credit. Such a policy is motivated in part by a belief that expansions of credit have a natural tendency to become excessive, setting the stage for subsequent financial crises and economic contraction. Certainly, the housing credit boom of the past decade appears, in retrospect, to have been such an example, one that imposed large costs on the economy in its wake. But not all expansions of credit are excessive, and judgments about when credit is supporting normal economic growth and

when it is creating imbalances and risks to financial markets and the economy are hard to make. So a policy that uses regulatory levers to lean against credit cycles brings with it the cost that it will sometimes suppress desirable expansions.

This tension — between curbing excessive growth and facilitating beneficial growth — is inherent in any effort to conduct countercyclical macroeconomic policy. Historically, countercyclical monetary and fiscal policy were often more focused on the flip side of this problem — seeking to stimulate growth in an economy that had slowed relative to what policymakers viewed as its potential. But on either side of the business cycle the problem is conceptually the same. The reasons for economic fluctuations — whether as measured by credit flows or other indicators — are many. Not all slowdowns are amenable to a policy correction and not all expansions require the application of policy brakes. Embarking on a countercyclical policy regime means accepting the likelihood of some mistakes.

This recognition suggests a cost-benefit approach to thinking about countercyclical policies. In his 1987 book *Models of Business Cycles*, Robert Lucas addressed this issue by asking how much consumption of goods and services one would be willing to give up on an annual basis in exchange for eliminating all the ups and downs associated with the U.S. business cycle since World War II. The answer was not much. Subsequent researchers have extended Lucas’ exercise to a richer class of models and found that the answer is somewhat more complicated, but his basic insight serves as a cautionary note for countercyclical policy. And the problem of trading off between the variability that comes with cycles and long-run average economic performance is likely to be even more complicated when it comes to credit and financial intermediation. Regulatory intervention into credit markets can be a powerful tool — but one used with caution. We should remember, for instance, that attempts to cool credit markets by introducing credit controls in 1980 swiftly brought on a sharp economic contraction.

So while financial regulation could benefit from attempts to measure and understand the sources of macroeconomic risks to financial institutions and markets and by monitoring the ways in which firms create exposures to those risks, it is important to consider how that information will be used. Using capital and other regulatory tools to lean directly against cycles in credit markets may sound desirable in the wake of the financial crisis, but doing so brings real risks as well — risks that, upon further reflection, we may decide outweigh the potential benefits of such a policy. **RF**

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