Does Macro-Pru Leak? Empirical Evidence from a UK Natural Experiment

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Comments by

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The Basic Idea

- FSA assigned bank-specific trigger ratios
  - Varied across banks
  - Varied over time
  - Effectively, contra-cyclical leverage

- Banks whose minimum capital ratios went up subsequently reduced their loans to the real sector.

Compliments

- Kudos for recognizing the natural experiment

- "Credit channel" of monetary policy.

- Inevitable question about loan supply vs. loan demand

- Less of a problem here than in many other cases.

The key findings are "cutback" and "leakage".

Together, these imply that
   a) bank equity is relatively expensive
   b) other institutions fill part of the gap
created by higher capital requirement.

Implications:
- **Theirs:** international coordination of contra-cyclical capital adjustments.
- **Another:** leakage into unregulated institutions if regulated banks' capital ratios rise.

A Cost of Requiring More Equity Capital

- Financial crises are very costly.
- It therefore seems tempting to raise equity requirements – a lot.
- What are the costs (if any) of doing so?
  - Reduction in regulated institutions' lending
  - Increase in unregulated institutions' lending.

In this paper, the unregulated institutions are supervised abroad.

What is the effect on financial system risk if the "leakage" institutions are outside <u>any</u> regulatory system?

- Risk will migrate out of banks

- Highest? Lowest?

- Should we expect to see/monitor those risks?

Econometric Suggestions

$$\Delta l_{it} = \alpha_i + \sum_{k=0}^{3} \beta_{t-k} \Delta KRR_{it-k} + \sum_{k=0}^{3} \gamma_{t-k} z_{it-k} + X\Pi + \varepsilon_{it}$$

1. Why just loans to the <u>real</u> sector?

2. Use branches to capture changes in loan demand.

3. Try aggregate loan volumes, in addition to sector-weighted measures of loan growth.

$$\Delta l_{it} = \alpha_i + \sum_{k=0}^{3} \beta_{t-k} \Delta KRR_{it-k} + \sum_{k=0}^{3} \gamma_{t-k} z_{it-k} + X\Pi + \varepsilon_{it}$$

4. Size differences?

a) Throw out largest banks (despite BIG dummy)

b) Is equity equally expensive for banks of all sizes?

c) Compare loan concentrations at regulated banks vs. branches

d) Buffer sizes might indicate something about cost of raising new equity.

$$\Delta l_{it} = \alpha_i + \sum_{k=0}^{3} \beta_{t-k} \Delta KRR_{it-k} + \sum_{k=0}^{3} \gamma_{t-k} z_{it-k} + X\Pi + \varepsilon_{it}$$

5. Can we see whether higher trigger ratios → more portfolio risk?

- Within the loan portfolio?
- Loans' share of total assets?

6. Extending one of the authors' preliminary points: it would be interesting to see if higher book capital requirements affect the market value of equity.

Conclusion

1. Good recognition.

2. Econometrics could be extended, but I suspect they will find similar results.

3. Implications extend beyond what the authors have noted …

4. … to illustrate a likely social cost associated with raising bank capital ratios.