

***Protecting Banks from the Cycle and Protecting the Cycle from the Banks  
Comments on Paper by Professor Repullo***

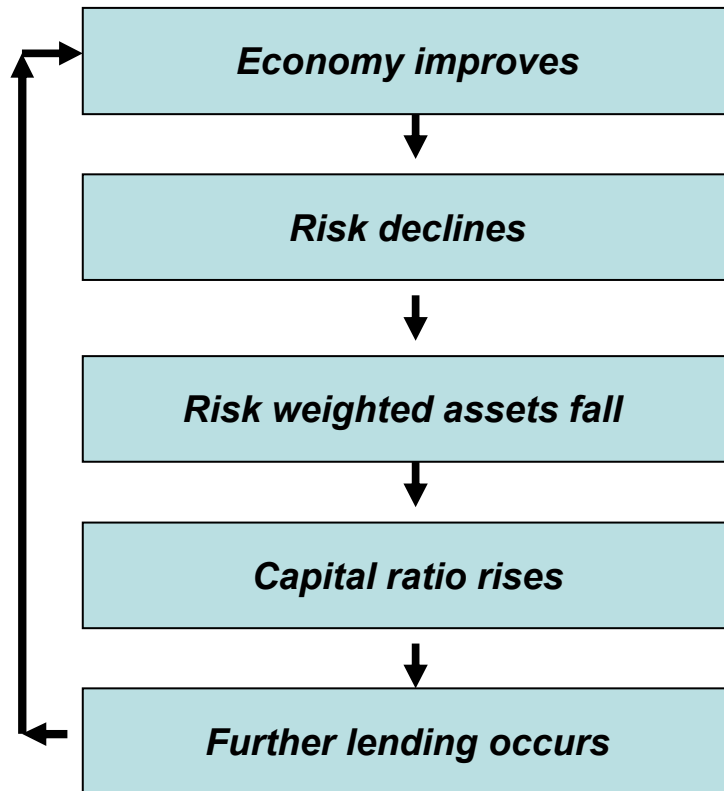
***CEPR Conference on the Future of Regulatory Reform  
London***

***4 October 2010***

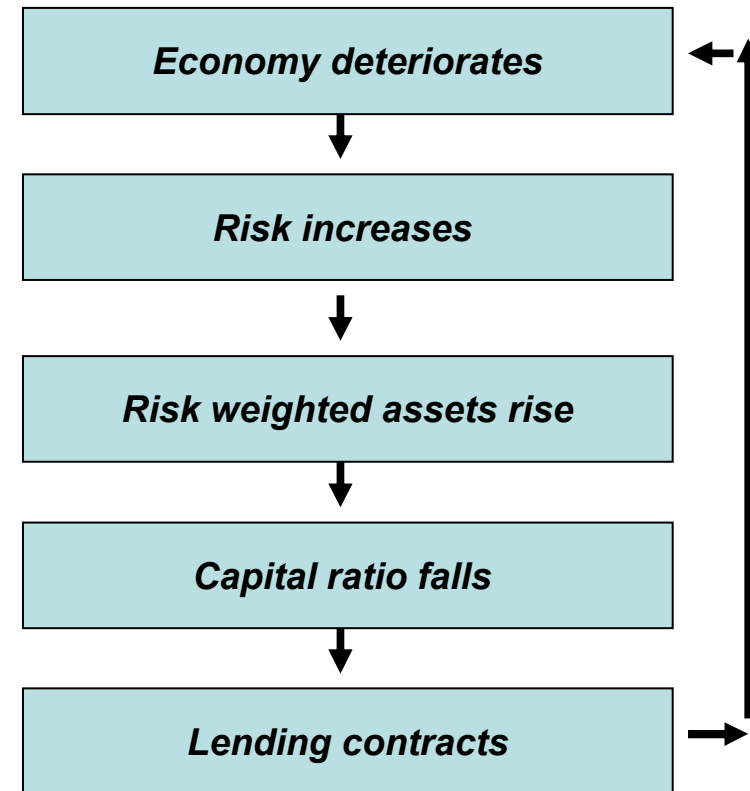
**Thomas F. Huertas  
Vce Chairman, Committee of European banking Supervisors  
Director, Banking Sector, Financial Services Authority (UK)**

# Procyclicality

*The upturn reduces requirements*



*The downturn increases requirements*



# Protecting the Banks from the Cycle (1)

× PIT PD

? TTC

? DLGD

*Requires some estimate of what the cycle will be*

## Protecting the Banks from the Cycle (2)

### ? **Countercyclical capital buffers**

- **Objective:**
  - “protect the banking sector from periods of aggregate excess credit growth”
  - “ensure the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth”
- **Judgmental not formulaic**
- **Changes the capital conservation buffer, not the minimum requirement**
- **Announcement effect**
  - Immediate
  - Increase in capital delayed 12 months
  - Release of capital immediate
- **Frequency of use: once every 10 to 20 years**

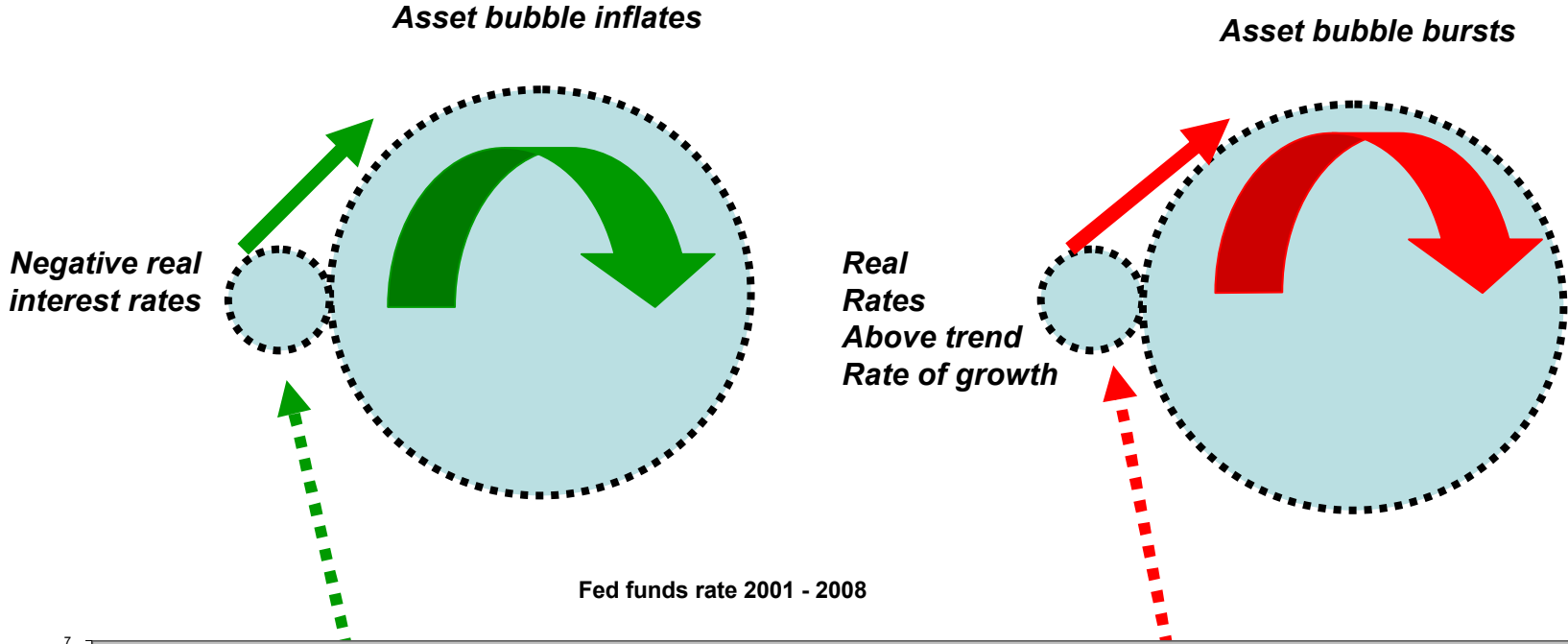
## **Protecting the Banks from the Cycle (3)**

- **Dynamic provisioning**
- ✓ **Stress testing/capital planning buffers**

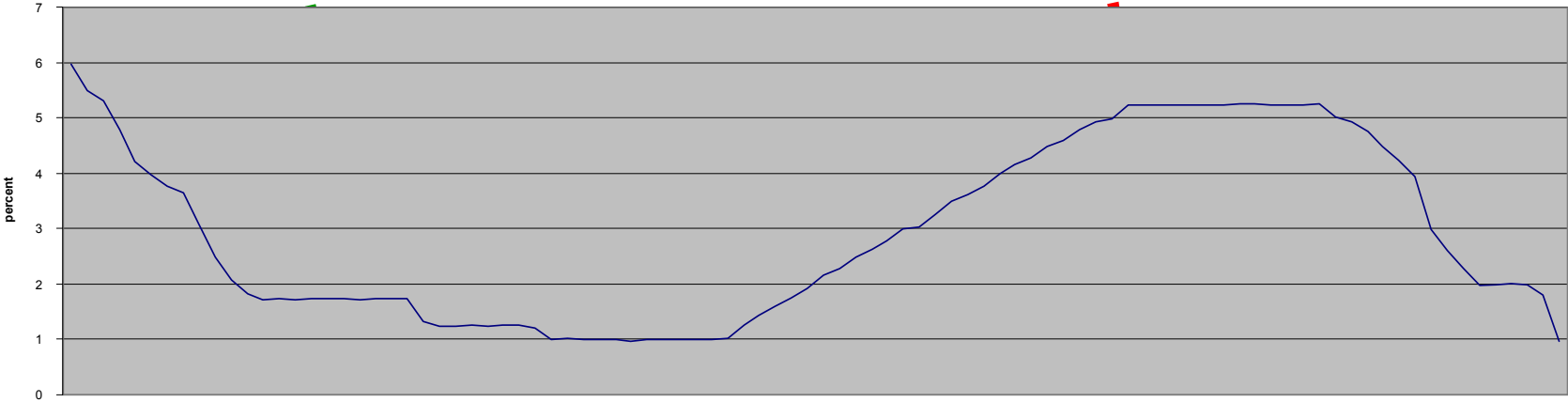
# Protecting the Cycle from the Banks (1)

- **Is there a “quantity theory of credit”?**
  - **Strong relationship between credit and GDP**
  - **Direction of causation: change in credit drives change in GDP?**
    - **In particular, if positive credit gap passes critical threshold, will this tip the economy into recession?**
    - **Is there a similar threshold on downside (if negative credit gap falls below certain threshold, does this spark a recovery?)**
- **Is this theory robust?**
  - **Does it hold for a constant monetary policy (unchanged interest rates?) or does the switch from boom to bust stem from changes in rates?**

# Does monetary policy rather than credit crank the cycle?



Fed funds rate 2001 - 2008



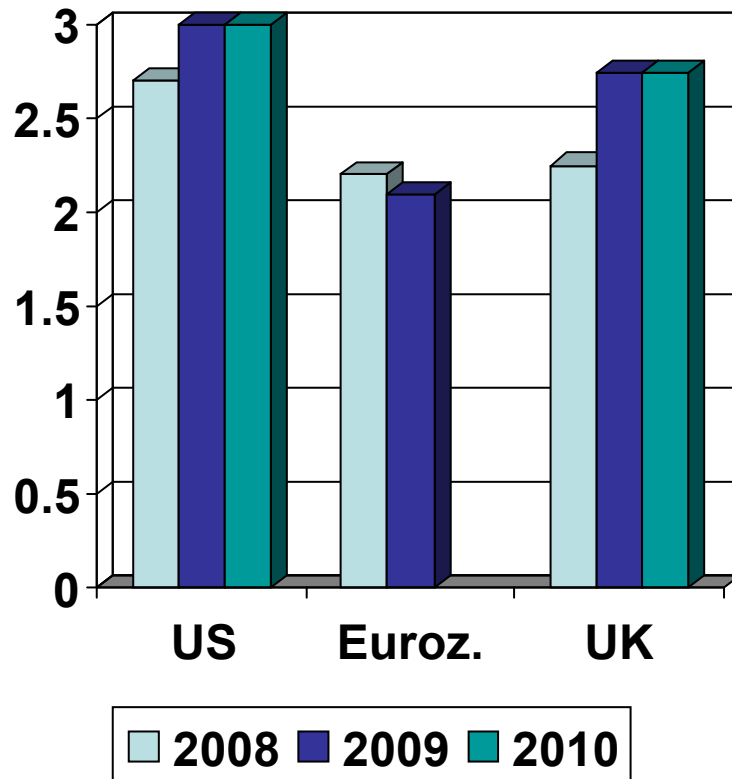
## **Protecting the Cycle from the Banks (2)**

- **Even if the quantity theory of credit is robust, is bank credit a good proxy for total credit?**
  - **To what extent will imposing a countercyclical capital charge on banks simply shift credit activity to the public markets?**
- **Even if the quantity theory of credit is valid, how will central banks know that credit growth has become excessive?**

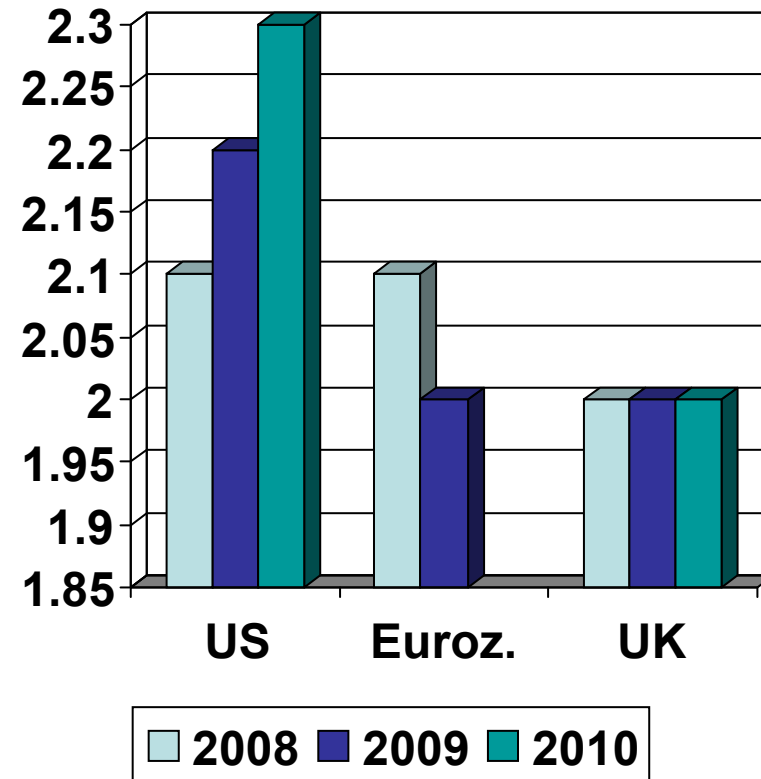
# Crisis, what crisis?

## Official forecasts, fall 2007

Real GDP forecasts fall 2007



Inflation rate forecasts fall 2007



Source: For United States: Economic Report of the President forecast made in November 2007; for Eurozone: European Commission, Directorate General for Economic and Financial Affairs forecast made in October 2007; for UK: Pre-budget report October 2007

## **Protecting the Cycle from the Banks (3)**

- **Are controls on borrowers (e.g. cap on LTV) more appropriate as a means of controlling total credit (and more effective in limiting risk of lending)?**