Prudential Policies and their impact on Credit in the United States

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Overview

- The current article analyzes the impact of two different forms of prudential regulation on <u>the supply</u> of two different types of credit:

    - SCAP and CCAR Stress Tests and Jumbo Mortgages.
    - 2013 IGLL (and 2014 FAQs) and Leveraged Lending.

- The article clearly proceeds through (i) description of supervisory framework, (ii) data set and (iii) estimation of panel regressions.

- The dependent variables studied cover <u>characteristics of bank supply of credit</u>: (a) the state-level share of CCAR banks on jumbo mortgage origination, (b) state-level approval rates of CCAR banks of jumbo mortgages and (c) share of syndicated term-loan origination at institution level.

- The authors find significant effects of the dates associated to these supervisory exercises on these supply characteristics mentioned, contributing to micro literature (loan and bank level data) on prudential policy (macro or micro prudential).

Supervisory Framework (Stress Tests)

- Supervisory Stress Tests have evolved significantly since the onset of the 2008 Financial Crisis:

  - Not a significant element of credit risk framework before the crisis.
  - Goals (SCAP and capital needs, CCAR and capital actions).
  - Use of supervisory models (limited in the first CCAR in 2011).
  - Range of scenarios and institutions covered.
  - The initial capital position of banks subject to the test.

- It is important to bear in mind, there is no mechanistic link between stress test results and credit growth, so the effect of stress tests will depend on different conditions: financial strength, methodology in place...

- The 2011 CCAR is associated with the greatest impact on the supply of jumbo mortgages even though it incorporated less extreme scenarios and the methodology was less developed. <u>The weak initial capital of banks in 2011 seems key</u>.

Supervisory Framework (Guidance on Leveraged Lending)

- 2013 IGLL and subsequent 2014 FAQs describe Federal reserve expectations on sound risk management practices of leveraged lending activities of regulated banks:

  - Supervisory guidance used more intensely in the 90s as response to credit excesses following deregulation (also in 2006 to try to limit concentration in Commercial Real Estate exposures).

  - The binding character of supervisory guidance depends on its timing (arrival after the battle is over) and the extent to which it leads to closer scrutiny of banks and to higher supervisory demands on credit standards.

  - 2013 IGLL seems well-timed given accumulation of this type of risk and the 2014 FAQs indicate active follow-up.

  - Leveraged Lending, i.e., lending to highly leveraged borrowers, is clearly characterized in page 15.

Data Set

- Home Mortgage Disclosure Act (HMDA) provides data on individual mortgage loan originations:

  - The authors aggregate the individual data to the institution-state-month and institution-state-quarter level (market shares or acceptance rates). <u>The total volume (or volume growth) is not directly modeled.</u>
  - The jumbo classification is based on a <u>size</u> limit for FMFM admissibility.

- The Syndicated National Credits (SNC) program covers syndicated loan activity (data coverage of originations with disbursement of at least $20 m):

  - Annual and quarterly (for most active agent banks since 2009) is used to build institution-quarter level shares of speculative syndicated loans over total originations.

Panel Regressions

- Section 5 presents very clearly the method and results of the fixed-effect panel regressions for the market shares and acceptance rates of jumbo mortgages:

  - Several specifications (state and bank level, control for below-median-capital, control for lagged capital ratio, interactions, etc.).
  - The dependent variables are insulated from demand effects.
  - Use of balanced panels.
  - Robust Clustered Standard Errors (state and time).

- Section 6 presents very clearly the method and results of the fixed-effect panel regressions for the share of speculative leveraged lending over total syndicated loans:

  - Analysis is now focused at the institution level.
  - Financial variables (junk bond appetite, S&P 500 VIX, CDX index, etc.) control now for demand conditions.
  - Several samples are considered: full sample, active institutions, non bank entities, etc.

Final Thoughts on Prudential Policy Evaluation

- The translation of prudential policy into quantitative variables (stress test capital deficit measures, target financial ratios, etc.) beyond dichotomous switches (policy is on/off) can help the measurement of policy effects.

- The confounding effect of other macro factors in place is hard to get rid of (we find a significant effect of time fixed effects in periods where we know regulation was introduced, but the net effect captures other elements).

- Ideally, we want to measure the impact on social welfare, but this goal is hard to implement in practice. As approximate measures, we might evaluate: (i) impact on total credit and non-performing credit (resulting for example from altering supply of credit), (ii) impact on GDP growth, (iii) impact on expected public cost of financial crisis, etc...

- Given the proliferation of instruments, it becomes more important to evaluate the consequences of a given policy mix (multiple equation system with multiple regulatory controls).

Thank you for your attention.