The Toolkit of Policies in the Brave New World of Debt

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EUROSYSTEEM
Agenda

1. What drives leverage?

2. What makes leverage a concern?

3. What policies can be used to mitigate the risks of leverage?
What drives leverage?
Leverage is driven by various factors

**Corporates (financial)**
- Tax shield – leverage can act as a gain (or loss) amplifier
- Easier to raise than external equity (i.e. barriers to equity financing)
- Protection of existing shareholders
- Cheaper than equity

**Households**
- Interest tax deductibility (promotes home ownership)
- For wealthier households, borrowing will be driven by the expectation of higher future income
- For the typical household, borrowing will be determined by the increase in asset values and the down-payment required by the lender
Debt levels are steadily increasing

Source: BIS credit statistics
Supported by record low borrowing costs...

Source: MFI Interest Rate Statistics, DNB
What makes leverage a concern?
Home-buyers are borrowing more... and more risky

Share of new loans with very high LTI, NL

Share interest-only in loan production per age category, NL

Source: DNB LLD & RRE
And structural vulnerabilities remain high

In the Netherlands, household debt is high...

... and home buyers are highly leveraged

Source: Eurostat

Source: DNB LLD & RRE
High leverage: Need for higher liquidity (i.e., regular cashflows and/or liquidity buffer).
If liquidity is insufficient: • Forced sales of illiquid assets
  • Cut spending
Adverse impact on: • The macroeconomy
  • Asset prices
  • Spillovers through direct links and common asset exposures
  • Market confidence
  • Liquidity position of financial institutions
What policies can be used to mitigate the risks of leverage?
<table>
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<th>Category</th>
<th>Banks</th>
<th>Non-banks</th>
<th>Households/corporates</th>
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<td><strong>credit growth</strong></td>
<td>• CCyB</td>
<td>• Leverage ratio (AIFMD)</td>
<td>• Tax regime</td>
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<td><strong>public/private debt</strong></td>
<td>• Sectoral risk-weights</td>
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<td>• Sovereign risk-weights/concentration limits</td>
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<td><strong>real estate markets</strong></td>
<td>• Discretionary measures</td>
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<td>• Sectoral risk weights</td>
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<td><strong>liquidity risk</strong></td>
<td>• LCR and NSFR (only micro)</td>
<td>• Liquidity risk management rules</td>
<td>• LTV/LTI/DSTI</td>
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<td>• Stricter national measures</td>
<td>• Suspension of redemptions (AIFMD/UCITS)</td>
<td>• Supply measures</td>
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<td><strong>systemic relevance/concentration</strong></td>
<td>• O-SII/G-SII buffer</td>
<td>• SII-framework</td>
<td>• Subsidies/tax regime</td>
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<td>• SRB</td>
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Legend:
- Available
- Limited effective
- Not available
- Non-existent
Recent measures in the Netherlands

1. Increasing risk weights for mortgages
   - Motivation: risk weights do not currently reflect the level of systemic risk in the housing market.
   - Main goal: improve the resilience of banks against a significant drop in house prices.

2. Introducing a new CCyB framework
   - Motivation: there is limited room to release capital in response to cyclical shocks.
   - Main goal: facilitate a more active use of the buffer to respond to cyclical risks.