

Key Aspects of Macroprudential Policy

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Teresa Daban Sanchez
IMF Resident Representative to Armenia

Motivation

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- The crisis has shown that systemic risks need to be contained by dedicated financial policies.
- Macro-prudential policy needed to achieve the stability of the system as a whole.
- While increasing use is made of macro-prudential policy, it remains work in progress.
- Extensive work by the IMF on building a framework that could guide the Fund's country specific advice, in coordination with other international bodies and country authorities

The global recovery remains fragile

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WEO Real GDP Growth Projections (Percent change from a year earlier)



World

U.S.

**Euro
Area**

**Emerging
markets**

China

Russia

2013 (April 2014)	3.0	1.9	-0.5	4.7	7.7	1.3
2014 (April 2014)	3.6	2.7	1.2	4.9	7.5	1.3

**2014
(Fall 2013)**

3.6

2.6

1.0

5.1

7.3

3.0

Source: IMF, *World Economic Outlook*.

Incomplete Transition of Global Financial Markets from Liquidity to Growth Driven Markets

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Areas of Advancement

What is going right

- Smoother tapering and green shoots in US
- Stronger banks and progress towards Banking Union in Europe
- Outflows contained and policies adjusting in Emerging Markets

Potential Challenges

What could go wrong

- Bumpier exit and financial risks in US
- Incomplete balance sheet repair in Europe
- Rising corporate debt burdens in Emerging Markets
- Systemic liquidity mismatches
- Geopolitical risks

Outline of the Presentation

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1. **Definition, objectives** and **tools** of macroprudential policy;
2. **Interactions** of macroprudential with **other policies**;
3. **Operationalizing** macroprudential policy;
4. **Institutional** and governance frameworks; and
5. **Multilateral aspects** of macroprudential policy.

Definition and Objectives

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- **Definition:** The use of prudential tools to increase resilience of financial system to systemic risks (IMF, 2011), and limit risk of disruptions to the provision of financial services that can cause serious negative consequences for the real economy.
- **Objectives:**
 - Building buffers that absorb the impact of shocks;
 - Time dimension :containing the build-up of systemic vulnerabilities (e.g. pro-cyclicality of asset prices and credit).
 - Structural dimension: limiting vulnerabilities that arises through inter-linkages (i.e. too important to fail).

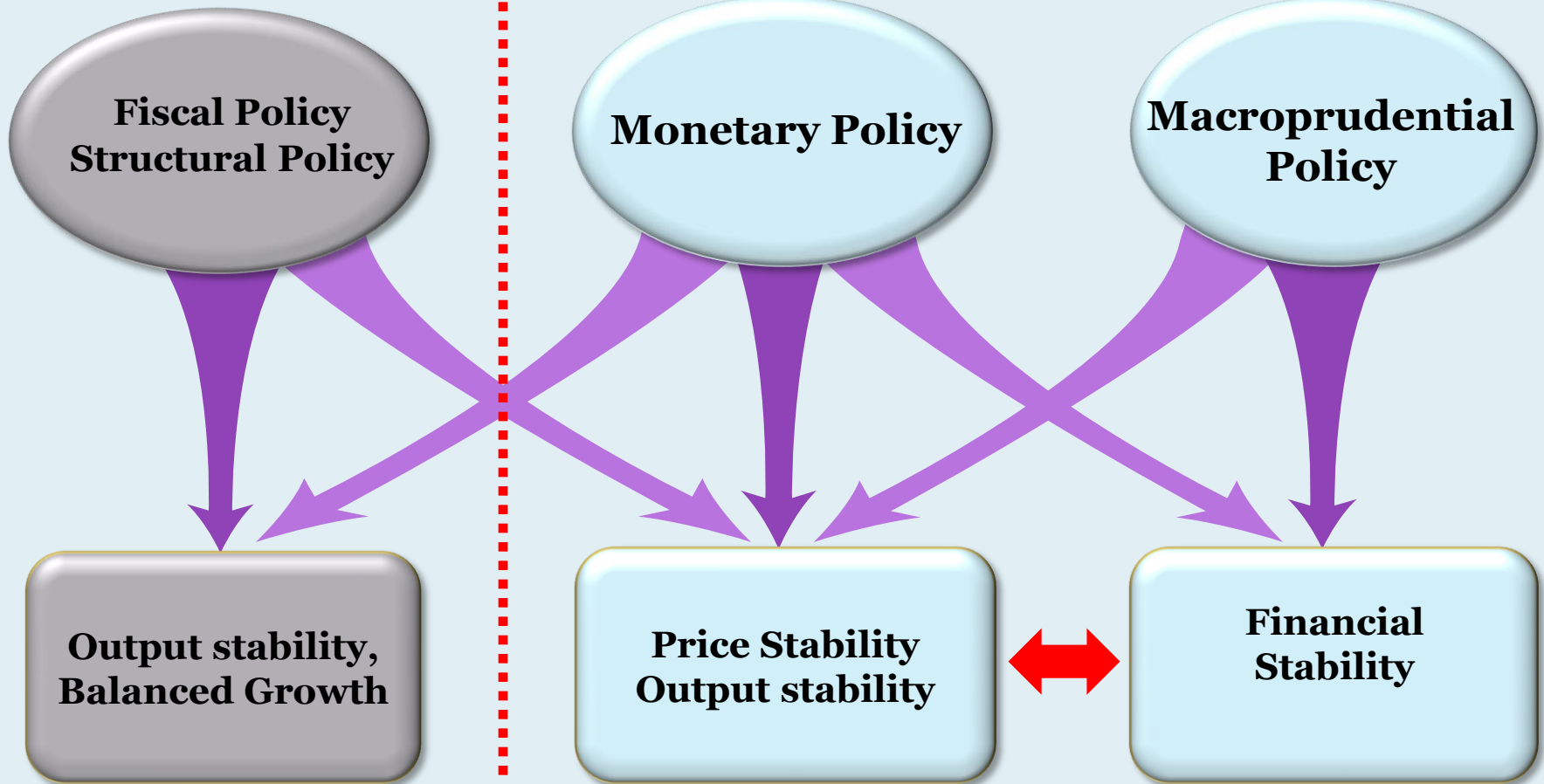
Tools, some examples...

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- Countercyclical capital buffers and provisions;
- Sectoral capital requirements;
- Measures to contain liquidity and FX mismatches;
- Caps on loan-to-value (LTV) and debt-to-income (DTI);
- Reserve requirements;
- Levies imposes on wholesale funding
- Regulation on takeovers...etc

Policies and Objectives

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Interactions with Other Policies

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- Strong **complementarities** between **monetary** and macroprudential policies. Where macroprudential has appropriate range of powers, it:
 - can contain side effects of monetary policy on financial stability
 - help monetary policy in the face of adverse financial shocks.
- Macroprudential policy should **not substitute** for **fiscal** and **structural** policy. Macro-prudential tools alone unlikely to be effective in addressing internal and external imbalances.
 - Coordination with other policies is needed including tax, competition, micro-prudential policies, banking supervision, and crisis and resolution policies.

Example: Microprudential Supervision

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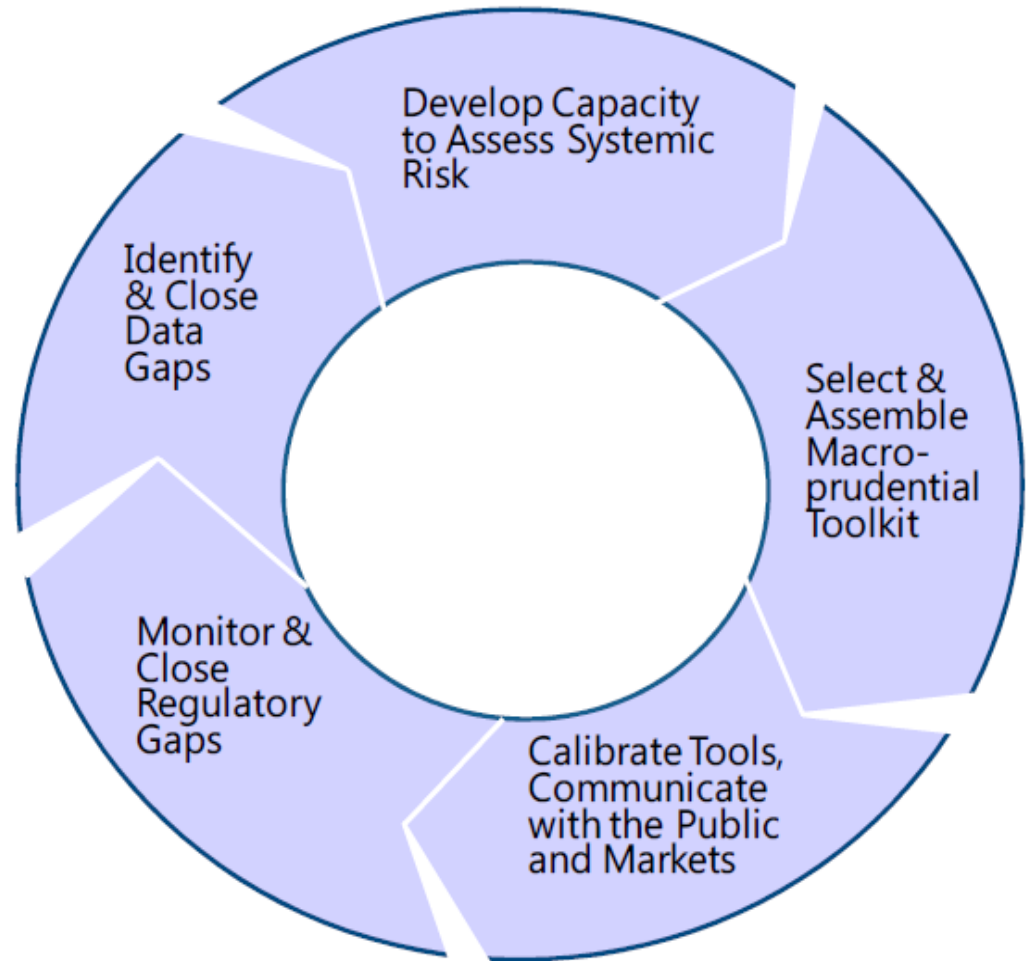
- **Complementarities.** Supervisory agencies are tasked not only to ensure the safety and soundness of individual institutions, but also to contribute to the stability of the system as a whole .
- **Tensions, especially in “bad times”.**
- *Macroprudential perspective:* relaxation of regulatory requirements that impede the provision of credit to the economy or contribute to fire-sale effects
- *Microprudential perspective:* to retain or tighten these requirements to protect depositors’ interest.

Operationalizing Macroprudential Policy

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- **Making macroprudential policy operational is challenging.**

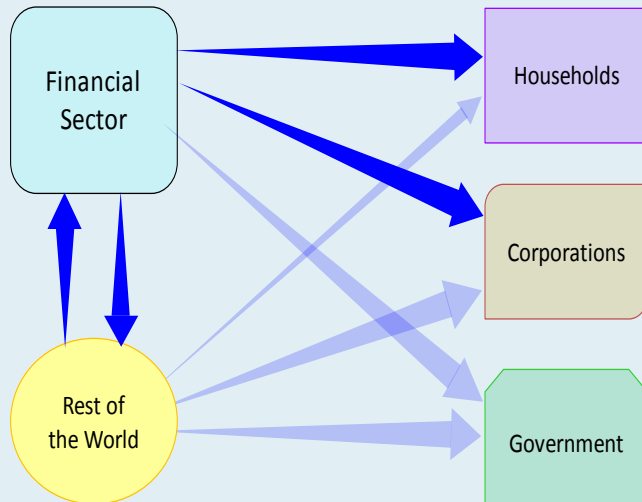
- Five key steps all require ongoing analytical and policy development.
- Still many unknowns and uncertainties.



Assessing Systemic Risks: Time and Structural Dimensions

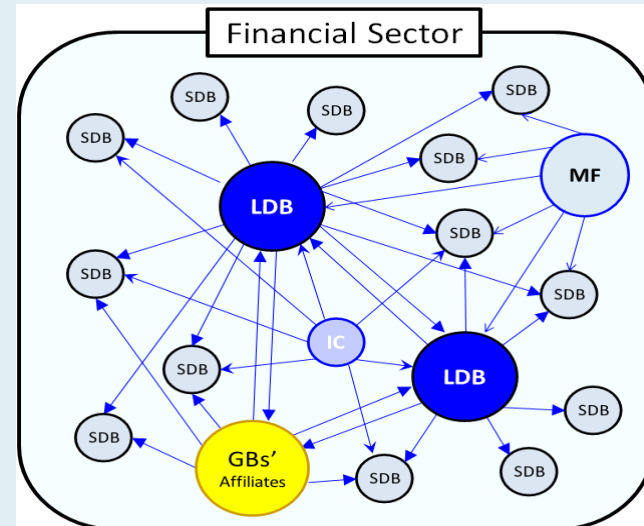
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Time dimension



Note: Arrows denote size of exposures .

Structural dimension



Note: Large Domestic Bank (LDB), Small Domestic Bank (SDB), Mutual Fund (MF), Insurance Company (IC), Global Bank (GB).

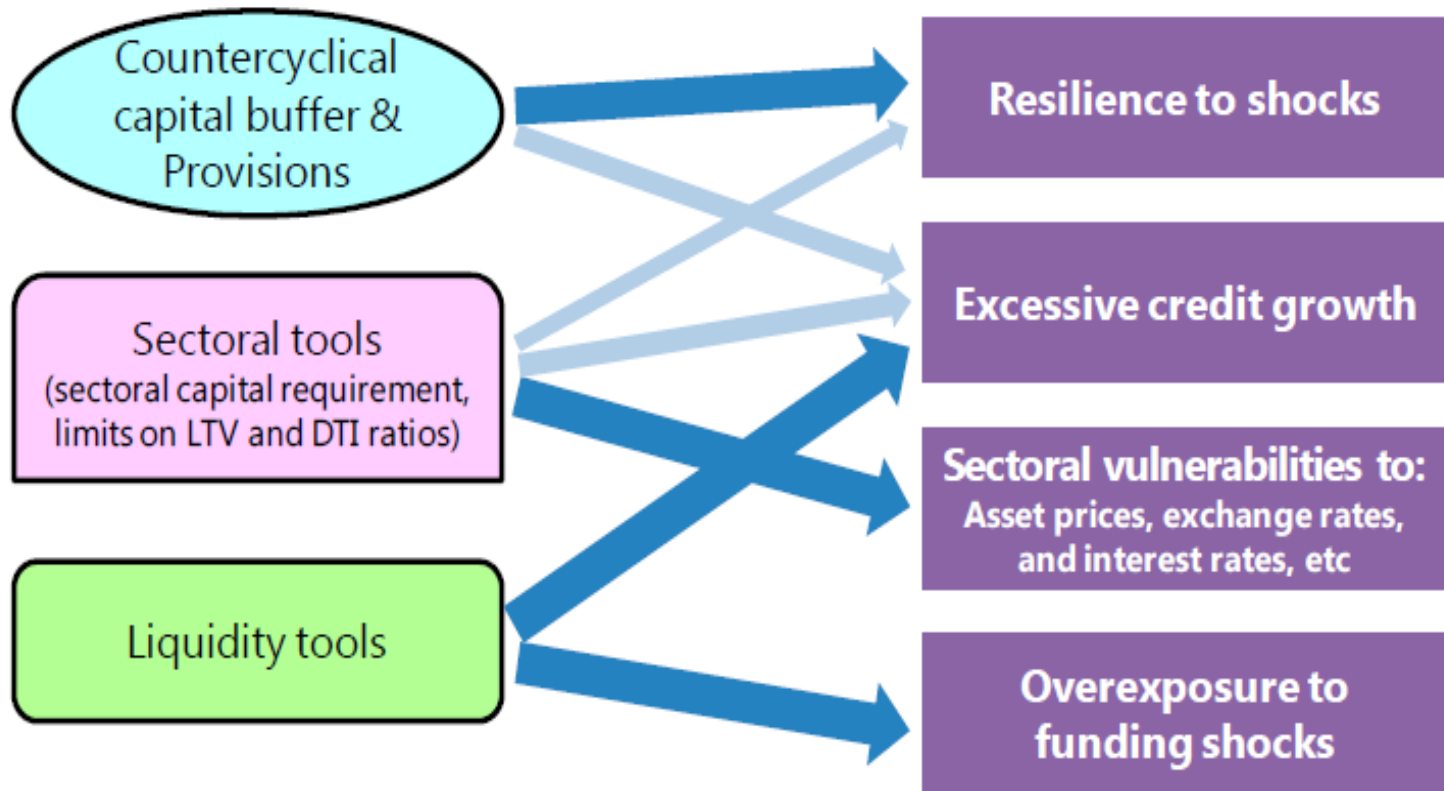
- **The analysis of systemic risk should consider**

- Credit relative to GDP (credit to GDP Gap); asset prices; macroeconomic imbalances; and build-up of vulnerabilities in both the household and corporate sectors;
- Financial linkages and funding risks within the financial system.

Assembling the Toolkit: Time Dimension

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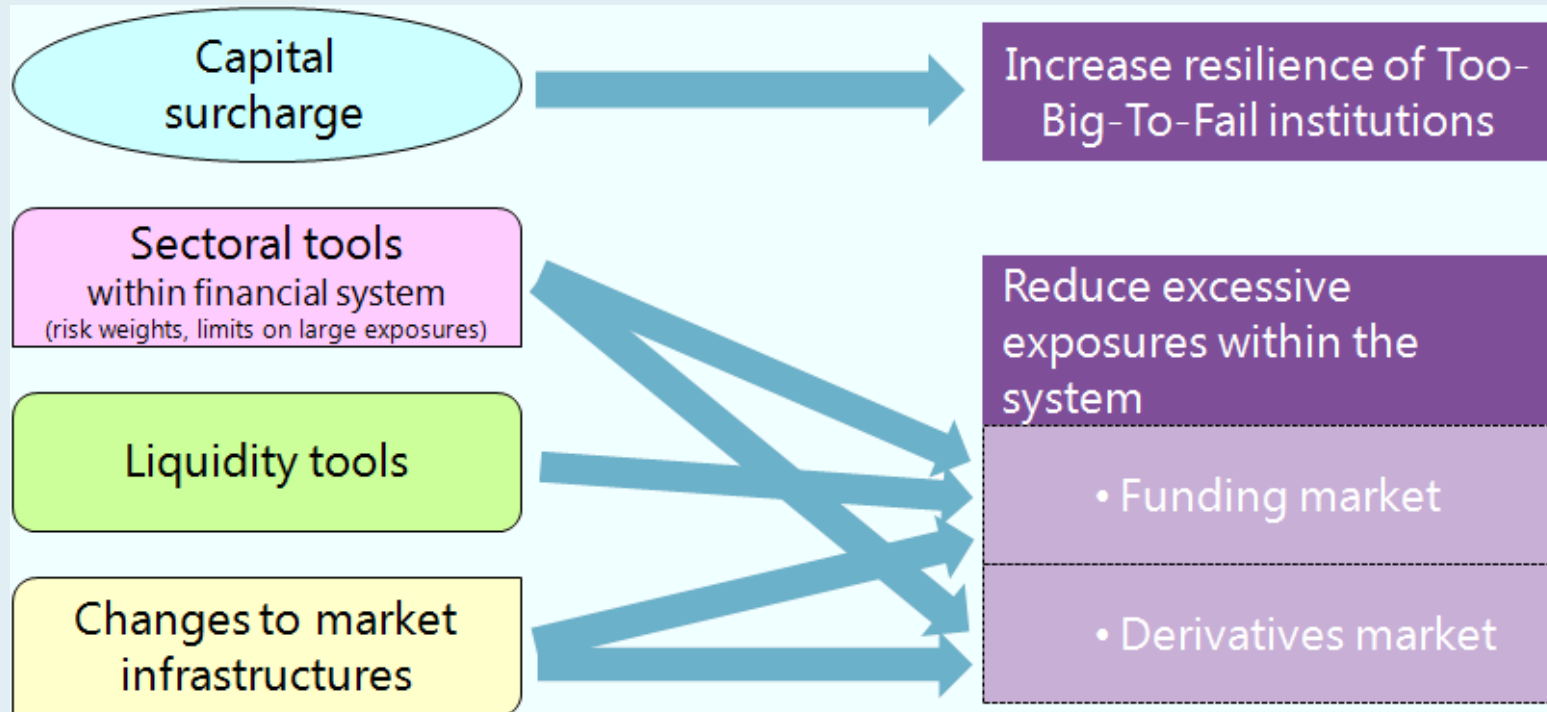
In the *time dimension*, a range of complementary tools can contain the build-up of systemic vulnerabilities.



Assembling the Toolkit: Structural Dimension

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In the *structural dimension*, a range of tools can contain risks from interconnectedness within the financial system.



Calibration of Tools I

- Need to map risk indicators to activation of tools
 - Examples:
 - Strong increases in ***credit to GDP*** (above trend increase) may call for activation of a **countercyclical capital buffer**.
 - Strong increases in **mortgage credit** and **house prices to rent/income** (above long-run average) may call for activation/tightening of household **Loan-To-Value/Debt-To-Income**.
 - Strong increases in **loans-to-deposits** may call for activation/tightening of **liquidity tools**.
- Indicators should not be used mechanically.
 - Need for judgment, taking in all relevant information, including supervisory information and intelligence on trends and market developments.

Calibration of Tools II

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- Ex ante communication is important.
 - A “strategy” to set out ex ante under what conditions tools will be used. Recent examples: Switzerland, Norway, New Zealand, United Kingdom
- Effects of tools on indicators should be monitored in real time, to gauge effectiveness and need for recalibration.
- Trade-offs in calibration may be particularly stark in stressed conditions.
 - Relaxation of macroprudential buffers can support the provision of credit in the face of **financial shocks**, thereby sustaining output.
 - But this must at the same time be mindful of the need to maintain **confidence** and to ensure the resilience to **future shocks**.

Monitoring and Closing Regulatory and Information Gaps

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- Financial activity tends to migrate out of the regulated sector and into the “shadows” (“boundary problem”). Example: Trust loans (China)
- Information gaps can hinder risk detection; design of measures; monitoring of migration of activity.
Example: Granular data on household indebtedness (e.g., Russia)
- Authorities need to be prepared:
 - Monitor migration and information gaps
 - Take mitigating action (e.g., expand the reach of tools)

Institutional Arrangements

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- **Basic principles:**

- To strengthen *‘willingness to act’*, it is important that the macroprudential mandate is assigned to **someone**, a body (existing institution) or a committee.
- It is desirable for the **central bank** to play an important role in macroprudential policy.
- To achieve *‘ability to act’*, macroprudential **objectives** and **powers** should be established in law.
- To guide their use, powers should be complemented by a range of **accountability** and communication mechanisms.

Effective macroprudential policy requires powers

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- When the financial sector evolves dynamically, powers are needed to
 - obtain information; wield policy tools; expand the range of action
 - beyond established prudential tools and existing regulatory perimeter.
- Useful to combine:
 - *hard* powers over specific macroprudential tools,
 - powers to *recommend*, coupled with *comply or explain*,
 - *soft* powers.
 - But soft powers alone are unlikely to be sufficient.

Multilateral aspects

Lack of action

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- **Issue:** A lack of timely action can impose substantial costs across borders, through trade and financial linkages.
 - Macprudential policy is subject to a strong bias in favor of inaction or insufficiently timely and forceful action as risks are building up.
- **Action:**
 - Strong institutional frameworks at the national level are essential to address biases in favor of inaction.
 - National frameworks can be buttressed by international guidance and surveillance.
 - Example: The IMF bilateral surveillance (Article IV and FSAPs) can strengthen the hand of national authorities.

Multilateral aspects

Need for coordination – action in the time dimension

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- **Issue:** Policies to contain excessive domestic credit can lead to an increase in credit provided across borders (“leakage”).
- **Action:**
 - Addressing cross-border arbitrage calls for “**reciprocity**” in the application of macro-prudential tools.
 - Bilateral and regional arrangements can ensure that reciprocity applies with full force and **across the range of tools** .
 - **Example: European Systemic Risk Board (ESRB) recommendation on FX risks.**

Multilateral aspects

Need for coordination – action in the structural dimension

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- **Issue:** Policies to strengthen the resilience of systemic institutions in one country can cause their activities to migrate to other countries.
 - This can lead to a **race to the bottom** and greater concentration of risky activities in less strictly regulated jurisdictions.
- **Action:**
 - **Calls for international agreements and guidance, complemented by surveillance.**
 - Determination of capital surcharges for global systemically important financial institutions (G-SIFIs) by the Financial Stability Board.
 - BCBS guidance for national authorities to assess capital surcharges for domestic systemically important banks (D-SIBs).
 - Surveillance (e.g., through FSAPs) can help foster implementation.

Multilateral aspects

Need for coordination – home-host issues

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- **Issue:** Where financial institutions have affiliates in multiple jurisdictions, this can
 - **complicate the assessment of systemic risk**
 - **lead to a range of conflicts between home and host authorities.**
 - Both **lack of action** and **action** by home (and host) authorities can have spillovers on other countries.
- **Action:**
 - **These issues require bilateral and multilateral coordination and consultation.**
 - European Systemic Risk Board (ESRB)
 - Nordic–Baltic Macroprudential Forum
 - Vienna initiative

Conclusions

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- The crisis has shown that systemic risks need to be contained by dedicated financial policies, aimed at achieving the stability of the system as a whole.
- A lot of experience with the design and implementation of macro-prudential tools, in the time and structural dimensions, but still, macro-prudential policy remains work in progress.
- Multilateral aspects and cross-country coordination are important. Extensive work by the IMF on building a such a multilateral framework.

References

International Monetary Fund, 2011, “Macroprudential Policy: An Organizing Framework”, Washington DC, International Monetary Fund

International Monetary Fund, 2013, “ key Aspects of Macroprudential Policy”, Washington DC, International Monetary Fund