Opening address by Mr. Alexandre Tombini, Deputy Governor for Financial System Regulation and Organization of the Banco Central do Brasil, at the Conference on “Macroprudential Supervision: Challenges for Supervisors”, organized by the IMF and the Korean Financial Supervisory Service, Seoul, November 7-8, 2006

Factors Affecting Financial Stability

On behalf of the Banco Central do Brasil I would like to thank the International Monetary Fund and the Korean Financial Supervisory Service for inviting me to be here today and to congratulate both institutions on organizing this Conference.

The theme of this session, “Financial Stability” is currently one of the most pressing issues in economic policymaking. Not only is it my pleasure to be with you today but I am also honoured to address such an important topic.

Most countries have now experienced long periods of economic and financial moderation. For this very reason, however, attention must be directed to identifying and anticipating potential sources that may affect financial stability. Consistent macroeconomic policies should be in place to mitigate the impact of shocks on the economy. Strong prudential regulation and supervision should be the norm so as to prevent isolated events becoming full-fledged financial crises, and macroprudential monitoring should be implemented to provide supervisory authorities the ability to anticipate economic and financial developments that raise the level of systemic risk.

In sum, we should continue to hope for the best, while still preparing for the worst.

In my remarks today, I would like to focus on what I consider to be the main factors affecting financial stability. I will discuss the main challenges in securing financial stability and make a few remarks on current developments in global financial stability. Before concluding, I will briefly address economic and financial developments in Brazil and the main challenges for financial stability in the coming years.

Main Factors Affecting Financial Stability

We all know why financial stability is important. Crises are costly events in terms of economic dislocation. The resulting financial distress usually takes time to dissipate. Monetary policy is profoundly affected by financial disruption, since important channels of transmission are interrupted. Fiscal policy as well is usually strained in such circumstances, requiring significant effort to restore macroeconomic equilibrium.

In trying to identify the main factors affecting financial stability, there are certain circumstances and conditions which can be listed as having the greatest potential for making financial shocks more likely to emerge or at least for facilitating the dissemination of financial disturbances.

First, increased cross-border integration and the presence of large international financial institutions facilitate the dissemination of financial shocks across countries. Cross-border integration linking markets across national boundaries, while allowing a more efficient international allocation of capital, has the potential of increasing financial contagion. We have seen a reduction in the so-called home bias with investors searching for investment opportunities in equity and debt markets around the world, and an increase in the preference for being present in local markets, as is also now the case in emerging market economies. The presence of large international financial institutions requires the authorities to adopt an integrated and consolidated approach as risks are transmitted internationally, increasing the complexity of their supervisory roles. Efficient cooperation between home and host supervisors is essential.

Second, financial innovation in products and markets, together with the existence of large financial conglomerates facilitate the transmission of financial shocks in domestic financial markets. The widespread use of securitization mechanisms may lead to increased concentration in credit markets. This is a trend that needs to be closely monitored as small and medium size banking institutions work as credit originators, packing and securitizing portfolios to larger banks. In particular, the quality of the origination process has to be closely monitored by larger institutions and by bank supervisors. In addition to the potential risk of concentration, the use of new and more complex financial products, such as credit derivatives, asset backed securities and others, allow risks to be transferred away from regulated institutions to agents not fully prepared to absorb those risks. Derivative instruments are quite helpful to deepen the underlying assets' markets and to improve the risk sharing across the economy; however, they tend to operate well only within a range of prices. Outside this range, derivative instruments tend to lose liquidity quite rapidly, becoming ineffective as hedging instruments and having the potential to augment financial shocks.

Finally, strong growth in asset prices and the growing importance of household credit are potential sources of financial instability. The well-documented boom in equity prices and more recently real estate prices, generate substantial wealth effects that when reversed can affect macroeconomic equilibrium in an adverse way, and can lead to misallocation of capital. The unwinding of stretched positions in these asset markets can be disorderly and have profound effects on financial stability. With low and stable inflation and lower interest rates household credit has soared in a number of countries. This is an important and favourable development that allows better inter-temporal allocation of resources, but also creates new challenges for bank regulators and supervisors.

Having identified those sources of potential instability, I would like to turn to challenges faced by central banks in pursuing financial stability.

<u>Pursuing Financial Stability: Challenges</u>

Risks to financial stability are likely to appear from time to time and therefore I find that the formulation of a **well-articulated strategy** to address potential financial imbalances should be a high priority on the agenda of central banks and supervisors.

This strategy, in my view, should cover the following areas:

Consistent Macroeconomic Policy Framework

The implementation of a consistent macroeconomic policy framework is crucial to maintain monetary and financial stability. The framework should be consistent in achieving its macroeconomic objectives and should avoid the buildup of imbalances that may lead to financial instability. Providing guidance to market participant as to how the policy operates helps smooth out the impact of policy decisions. In addition, flexibility to react to shocks that often affect the economy helps mitigate the risks of generating financial crises. The combination of a forward-looking monetary policy, aiming at a low and stable inflation, a flexible exchange rate regime and fiscal discipline is one meaningful macroeconomic policy framework that has served well a number of countries in supporting financial stability. This has been the case of **Brazil,** where the policy framework has been quite instrumental in reducing the economy's risk premia.

Financial System Monitoring

The use of monitoring tools, including macroprudential analysis focused on the financial system as a whole, is of utmost importance to identify potential sources of instability, to limit system-wide distress, and to avoid large output costs. Therefore, it is necessary to have relevant, reliable, timely, and complete standardised data. It is important to note, however, that such information is distorted and meaningless if similar accounting standards are not adopted. It is also important to periodically perform systemic stress tests to analyse the potential impact of adverse macroeconomic shocks under various economic conditions and with different monetary policy responses.

Market Infrastructure

Market infrastructure plays a central role since financial stability is greatly influenced by the environment in which intermediaries operate. Just as there are cultural differences, there are also structural differences across countries. Nations have diverse history, values, political and economic systems, legal frameworks, and taxation structures which play a central role in the development of their singular financial systems. Those national influences interact and certainly affect practices and procedures. Thus, a modern system of contract law, bankruptcy law, efficient judicial proceedings, accounting and auditing standards, corporate governance practices, transparency and data dissemination requirements, not to mention an efficient payment and settlement system, are all required as a basis for a resilient financial system. I should also mention the need for a modern deposit insurance scheme, provided it is organized in a way that does not heighten moral hazard. Having an effective credit bureau, containing both positive and negative credit information regarding potential borrowers, is very instrumental to ensure the quality of origination.

Safety Buffers

Safety buffers must be built in good times to face unexpected instability. Such buffers could include: self-insulation against external shocks through the accumulation of international reserves, reducing the volatility of exchange rate movements, mitigating the impact of adverse developments on domestic prices and, therefore, lowering the probability of financial disruption; and definition of required regulatory capital in appropriate levels to deal with unexpected losses in the asset portfolio, respecting the business cycle without inappropriately reducing the supply of credit.

Adoption of Common International Standards

Adherence and convergence to high-quality standards and practices are one of the key ingredients for the efficient allocation and use of scarce economic resources and are expected to lower the cost of capital and reduce room for regulatory arbitrage. With increased globalization and interdependence of the world economy, financial intermediaries need to operate on a level playing field. Unnecessary market burdens or restrictions only create competitive distortions.

Corporate Bonds and Securities Market

The strategy should also articulate the development of markets and financial instruments to raise private capital for the financing of long-term investments, especially considering the growing pension fund and insurance industries and the appetite of international investors. It is also important to have strong and liquid secondary capital markets.

Enhance the Quality and Availability of Cross-Border Information to Stakeholders

Enhancing the quality and availability of cross-border information facilitates the decision-making process, risk evaluation and pricing of financial instruments. With the acknowledged advances in communication channels and tools, and also computer technology, timely access to, and storage of, data has made market analysis less costly and much faster.

With a growing number of firms listed in world-wide markets seeking to lower the cost of capital, and with international investors looking for investment opportunities with higher returns across countries, better disclosure, high quality accounting regimes, transparency, and good governance are necessary.
With regards to country specific information, "financial stability reports" can be used to enhance the quality of information.

Risk management

The strategy should also encourage the development of prudent and efficient internal risk management systems, ensuring that they are properly monitored and managed, relating regulatory requirements to risk management practices and increased transparency.

Market discipline

Market discipline must be fostered through prudential regulation and supervision, enabling market forces to exert discipline. Moral suasion, reprimands, and penalties are potential measures to be taken by supervisors when failure to comply with regulations is identified. It is also important to note that market participants must have the right incentives to exert discipline; the correct instruments to exercise discipline; sufficient information to more accurately assess the financial position and performance of an enterprise; and the ability and time to process information correctly.Timely public disclosure can also reduce the severity of market disturbances, since market participants are informed on an ongoing basis, and thus are not as likely to overreact to information on current conditions.

Cooperation

Supervisory authorities around the world and multilateral institutions should foster international cooperation through the exchange of views and ideas (this Conference being an example), and by enhancing information sharing between home and host supervisors (e.g. memoranda of understanding, regular meetings, regional associations). Data dissemination (e.g. IMF's SDDS) and regional coordination are particularly important when a domestic crisis could spread across countries with similar economic structures or close financial linkages.

Domestic supervisors, such as the central bank, the ministry of finance, the securities regulator, and the deposit insurance institution, should cooperate through the effective exchange of information and establishment of global directives for market participants. Cooperation and coordination are essential in dealing with systemic crises.

<u>Global Financial Stability: a few considerations</u>

Turning to current developments in global financial markets, I would like to make just a few considerations.

The increase in volatility in the second-quarter of 2006 reminds us of the need to implement sound macroeconomic and prudential policies in an environment of widespread financial leverage. The years of macroeconomic and financial moderation have created an environment of high liquidity in major currency areas and, together with the growing importance of cross border transactions, have raised the bar for policymakers and supervisors around the world in terms of maintaining global financial stability.

Guidance to international markets from the central banks of major economies is necessary given the potential spill over effects across markets and countries. With the recent uncertainty as to the true cyclical position of major economies – characterized by uncertain outlook for inflation and economic growth – the value of ensuring clear communication of policy intentions is at a high premium. Despite the wide range of economic and financial data available on a real-time basis for the public to form judgement, a central piece of information is how the monetary authorities interpret those data. Misinterpretation of monetary authorities' policy intentions is likely to amplify financial shocks and cause unnecessary turbulence in an environment of highly leveraged positions and cross border transactions.

Another issue that I would like to raise here is the challenge in dealing with credit cycles associated with cross border financing. The challenges involving domestic-driven credit expansion cycles, in particular household credit, are well-documented in the September 2006 "Global Financial Stability Report".

However, when external financing drives the credit cycles, the issue is more complex and policy prescription to deal with such developments is less straightforward. In dealing with credit expansion of that nature, the first policy recommendation is to implement appropriate fiscal and monetary policies. Often, while these policies might be effective in containing aggregate demand and in neutralizing the impact of credit expansion in the first place, they may end up improving market sentiment and attracting even more capital in a context of ample global liquidity.

In this regard, I believe further investigation needs to be undertaken on macroeconomic and regulatory policies in major market economies with a view of making the cycles of global liquidity more predictable and less volatile, thus helping to ensure global financial stability.

Recent Economic Developments and Challenges for Financial Stability in Brazil

Allow me to turn to some brief considerations about recent economic developments and challenges in my region.

Latin America continues to enjoy robust growth for the third successive year, which has helped achieve further reduction in unemployment and poverty. Improvements in macroeconomic stability have not only provided an important foundation for continued economic expansion, but have also placed the region in a stronger position to take advantage of global opportunities and to be better prepared to face the more challenging international environment.

In most countries, inflation has remained well under control. Progress towards price stability has reinforced the growing credibility enjoyed by monetary policy frameworks. All these factors have contributed to lower interest rates in a number of countries and helped support increased credit and investment levels.

Brazil itself has undergone enormous changes over the past several years on the macroeconomic front. Inflation has been brought under control supported by fiscal consolidation, and by a monetary policy framework combining floating exchange rate and inflation targeting. Under this macroeconomic policy framework and taking advantage of a favourable global economic environment, the country made a remarkable turnaround in its external position. The trade balance presented a record surplus of over USD 45 billion this year, helping restore confidence in the economy, thus reducing risk perception to a record low.

The Brazilian financial services industry has benefited in the last decade from increasing global economic and financial integration. Not only has the activity of foreign banks increased, providing a wide range of financial services and influencing competition, but also the growing volume of cross-border capital flows has brought about new opportunities and challenges. The financial system, which benefits from high capitalization and high quality of regulation and supervision, has proved its resilience, weathering well a number of shocks that occurred in the 1990s and in the early 2000s.

In this new environment of monetary stability, the Brazilian prudential regulation and supervision have also undergone a series of important changes with the main objective of reducing systemic risk and enhancing market discipline. When it comes to market discipline measures, the Brazilian auditing regulation was revised in 2003 to incorporate several international recommendations, such as mandatory auditing committees – an important measure that also helps to foster good corporate governance and depositors and investors protection.

As to accounting, regulations were issued to incorporate some IASB's standards, including the fair value criteria for the valuation of bonds, securities and financial derivatives. Furthermore, we have decided to speed up the pace of the convergence process by implementing a strategic project that seeks convergence to IASB's standards by 2010.

On the supervisory side, we have signed a number of cooperation agreeements with supervisors, generally through memoranda of understanding. We have also adopted a risk-based supervision focus, in a consolidated basis, including all activities under the controlling banking organization.

Basel II is also a top priority on our agenda. We published a road map for implementation back in December 2004, which covers implementation steps until 2012. We expect at the end of this process to have a handful of banks operating in Brazil adopting internal models for the management of credit, market and operational risks.

Looking forward, the challenge in Brazil, with respect to financial stability is, in my view, threefold:

First, we need to continue to persevere with the implementation of sound and consistent macroeconomic policies. This will allow us to achieve our macroeconomic goals while keeping overall financial risks at low and manageable levels. Further reducing macroeconomic vulnerabilities will also provide the necessary basis to mitigate the impact of economic shocks on domestic financial conditions, thus reducing the incidence of crises.

Second, as fiscal consolidation advances, the debt-to-GDP ratio should continue to fall, leaving room for private credit to grow in the years to come. Greater share of private domestic credit-to-GDP, while highly desirable, will require enhanced attention from financial institutions on managing credit and other risks and close monitoring from our bank supervision. On the regulatory front, we should continue to advance in fostering ways to improve risk sharing across institutions, including those outside the banking system.

Third, we should find the appropriate balance, in the period ahead, between fostering greater competition in the financial system on the one hand and securing financial stability on the other. I believe there is enough room to be exploited before this trade-off becomes biding.

Conclusion

In closing I would like to make a few additional remarks.

The financial system plays an essential and growing role in most economies in the allocation of economic resources, mainly through the integration of markets, implementation of new technologies, competition and product innovation. When assessing potential sources of financial instability in an ever changing business environment, surveillance of markets, institutions and infrastructure is crucial. This surveillance should be combined with robust macroeconomic policy frameworks, prudential regulation aimed at establishing capital buffers and fostering market discipline, and appropriate supervisory tools.

Furthermore, it is important to take advantage of the still benign global economic and financial environment to enhance the financial system's infrastructure, including legal, judicial and payment and settlement systems, to mention a few, and develop strong cooperation among domestic authorities and between home and host supervisors.

Finally, I would like to recall that the long cycle of stability that we currently enjoy may have softened the defenses of the global supervisory community. Going forward, however, there should be no room for complacency. Countries should take advantage of the still favorable global financial and economic conditions to prepare themselves for more challenging times.

Thank you!