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Key Aspects of Macropurudential Policy

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Issues to discuss

- Motivation for macroprudential policy
- Definition, objective, and rationale
- Interactions with other policies
- Operationalizing macroprudential policy
- Institutional foundations
Motivation for macroprudential policy
Why macroprudential policy?

- Perception that “traditional” prudential regulation and monetary policy did not prevent the financial crisis ➔ policy gap
Macroprudential policy aims to fill this gap

- **Monetary Policy**
  - Price Stability
  - Economic Activity

- **Macroprudential Policy**
  - Financial Stability
  - Systemic Risk

- **Microprudential Policy**
  - Idiosyncratic Risk
Increasing use of macroprudential policy

Macronudential policies: cumulative actions by region
(Average per country in each region: 2000Q1-2013Q1)

Index summing up housing-related measures, credit measures, reserve requirements, dynamic provisioning and core funding ratio. Simple average across countries within country groups.

Source: Zhang and Zoli, 2014
Definition, objective, and rationale
Definition

• Defined as the use of primarily prudential tools to limit **systemic** risk (BIS, FSB, and IMF, 2011)

  - Risk of disruptions to the provision of financial services that can cause serious negative consequences for the real economy

  - Macroprudential policy seeks to address systemic vulnerabilities
Objective

- Main objective: Prevent systemic financial vulnerabilities
  - The global crisis has underscored the costs of systemic financial instability
  - Advanced economies are still struggling to recover after almost 10 years
- Avoid overburdening it with additional objectives
- Intermediate objectives:
  - Increase the resilience of the financial system to aggregate shocks
  - Contain the buildup of systemic vulnerabilities over time
  - Control structural vulnerabilities within the financial system
The rationale for macroprudential policy rests on the presence of three sets of financial externalities:

- Financial systems tend to amplify adverse aggregate shocks
- Macro-financial feedback mechanisms ➔ overexposure to adverse aggregate shocks
- Linkages within the financial system increase the vulnerability of the system to idiosyncratic or aggregate shocks
Interaction with other policies
Macroprudential policy interacts with other economic policies (conflicts and synergies)
Particularly important is the interplay with monetary policy ...

- Monetary and Macroprudential policies complement each other
  - When low interest rates induce risk taking, macroprudential policy may help to contain such risks
  - Where buffers are created, there are fewer chances that interest rates will hit the zero bound when financial shocks materialize
... and not less important with microprudential policy

• Synergies and potential conflicts
  - Synergies: individual health is good for systemic health and vice versa
  - Conflicts: when facing adverse shocks, macroprudential calls for relaxation of regulatory requirements while microprudential seeks to tighten them
  - Solution: clarify roles, assign tools, and introduce coordination mechanisms
Operationalizing macroprudential policy
A challenging task

- Macroprudential policy an ongoing process
  - Five key steps, all require ongoing analytical and policy development
  - Best supported by a dedicated unit or department, that keeps the “policy wheel” moving.
  - Still many unknowns and uncertainties
1. Assessing systemic risk

The analysis of systemic risk should consider:

- Credit relative to GDP (credit / GDP gap), combined with analysis of asset prices and macroeconomic imbalances
- Financial linkages and funding risks within the financial system

Note: Arrows denote size of exposures.

Note: Large Domestic Bank (LDB), Small Domestic Bank (SDB), Mutual Fund (MF), Insurance Company (IC), Global Bank (GB).
2. Assembling the toolkit (time dimension)

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

  - **Countercyclical capital buffer & provisions**
  - **Sectoral tools** (Sectoral capital requirement, limits on LTVs and DTI ratios)
  - **Liquidity tools**
2. Assembling the toolkit (structural dimension)

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

- **Capital surcharge**

- **Sectoral tools**
  - Within financial system
  - (risks weights limits on large exposures)

- **Liquidity tools**
3. Calibration of tools (1)

- Map key indicators to activation of tools
  - Strong increases in:
    - *Credit to GDP* (above trend) ➔ countercyclical *capital buffer*
    - *House prices to rent/income* (above long-run average) tightening *LTVs*
    - *Debt-service to income* ratios (above long-run average) tightening *DTIs*
    - *Loans-to-deposits* ➔ tightening *liquidity tools*

- Indicators should not be used mechanically (judgement, relevant information, country-specific circumstances)

- Effects of tools on indicators should be monitored in real time to gauge effectiveness
3. Calibration of tools (2)

- Ex-ante communication is important
  - Setting out ex-ante under what conditions tools will be used can have helpful effects on behavior of market participants (Switzerland, New Zealand, United Kingdom)

- 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
  - But this must at the same time be mindful of ensuring resilience to future shocks
4. Monitoring and closing regulatory gaps

- Whenever prudential tools are binding, financial activity tends to **migrate** out of the regulated sector into the “shadows”
  - Examples:
    - Trust loans (China)
    - Provision of mortgage credit by finance companies (Korea)
    - Provision of credit off-balance sheet (USA and Europe)

- Can also migrate to **other jurisdictions**

- Authorities need to be prepared
  - Monitor migration
  - Take mitigating action (e.g., expand the reach of tools, coordinate)
5. Closing information gaps

- Information gaps can hinder
  - Detection of risks, design of measures, monitoring of migration of activity

- Examples of information gaps
  - FX exposures of the corporate sector (Brazil, Mexico, 2008)
  - Granular data on household indebtedness (Russia)
  - Exposures and funding links within the financial system (in particular between the regulated and unregulated sectors)

- Authorities need to close data gaps that impede analysis and mitigation of risks
Institutional foundations
Institutional models vary according to different characteristics

1. Institutional integration between central bank and supervisory agencies
2. Ownership of macroprudential policy mandate
3. Role of the government
4. Separation of policy decisions and control over instruments
5. Existence of a separate body coordinating policy decisions
Three main models

1. Integrated in the Central Bank
   - Czech Republic, Ireland, New Zealand, Serbia, Singapore, ECB

2. Dedicated committee within the central bank
   - UK, Malaysia, Thailand, Romania

3. Committee outside the central bank
   - United States, Germany, Turkey

- Each with pros and cons.
“Rules” can help overcome political economy challenges, and create predictability and political acceptance. However,

- The policymaker needs to retain discretion to respond flexibly to changing financial conditions.
- Macroprudential policy requires judgment based on all information.
  - including market intelligence and soft information.

Macroprudential policy is therefore best supported by “guided discretion,” based on indicators, but complemented by judgment.
Basic principles

- Strengthen ‘willingness to act’ ➔ macroprudential **mandate** should be **assigned** to an agency or committee

- Also important is to foster ‘ability to act’ ➔ macroprudential **objectives** and **powers** should be established in law

- Powers should be complemented by a range of **accountability** and communication mechanisms

- It is desirable for the **central bank** to play an important role in macroprudential policy
Powers for what?

• To optimize obtaining information

• That allow authorities to expand the range of action
  - Beyond established prudential tools
  - Beyond the existing regulatory perimeter

• Useful to combine
  - *Hard* powers over specific macroprudential tools
  - Powers to *recommend*, coupled with *comply or explain*
  - *Soft* powers (although alone are unlikely to be sufficient)
The UK model

- The FPC is responsible for macroprudential policy.

- The PRA is moved back to the BoE, leaving outside a new Financial Conduct Authority (FCA).

- FPC composition balances coordination, expertise, and external challenge.
  - 4 BoE members (3 sit on MPC).
  - Heads of PRA and FCA.
  - 4 external members.
  - 1 Treasury delegate (non-voting).

- FPC: Financial Policy Committee.
- PRA: Prudential Regulatory Authority.
- MPC: Monetary Policy Committee.
The Mexican model

Financial System Stability Committee
(Chaired by Minister of Finance)

- Deputy Minister of Finance
- Governor and 2 Deputy Governors
  - Bank of Mexico
- Executive Secretary
  - of the Institute of Savings Protection

- President of National Commission of Banks and Securities
- President of National Commission of Insurances
- President of National Commission of Pension Funds
- Deputy Minister of Finance
- President of National Commission of Banks and Securities
- Executive Secretary
  - of the Institute of Savings Protection
Final Remarks

- Goals and scope of macroprudential policy should be clearly defined. Not overburden.

- To achieve its goals, macroprudential policy must have the support of strong supervision and enforcement.

- And also of appropriate monetary, fiscal, and other financial sector policies.
  - Macroprudential policy, in turn, can help these other policies achieve their goals.

- Macroprudential policy is a work in progress.