

Macro-Prudential Policies: Asian Perspectives
Shanghai, China, October 18, 2010

Session II: Components of macro-prudential regulation—systemic risk, taxes, bank capital policies

This session focused on use of macro-prudential tools with the objective of mitigating the build-up of systemic risks and spillover effects across markets and institutions in the event of shocks. All participants noted that there is much work that remains to be done in order for the authorities to correctly identify excesses, decide on what instrument(s) to use as well as the appropriate time and the right dosage.

The participants discussed the shortcomings of the Basel 2 approach and elements of macro-prudential policies in the recent Basel 3 amendments. In particular, they noted the reliance on risk weights in times of booms where low measured risks lead to low buffers and excessive asset growth. Risk measurement (delinquency and default rates and value-at-risk) can be/was backward looking and thus measured risks are likely to decline at a time when credit growth and asset (collateral) price are on the rise. An example of the procyclicality of the regulatory regime was demonstrated in the case of an Irish bank for which the capital adequacy ratio remained very high and non-performing loans remained very low. However, non-performing loans jumped from 0.5% to 48% between 2007 and 2009. There was a short discussion on how Basel 3 seeks to counter these procyclical effects (in terms of valuation adjustments to avoid misstatement of both initial and subsequent profit and loss recognition at times of significant valuation uncertainty and robust methodologies for loan loss provisioning that reflect expected credit losses through the life of the portfolio).

The discussion then focused on the macro-prudential overlay of Basel 3: the capital conservation buffer, the countercyclical buffer and measures for additional loss absorbing capital (especially for SIFIs). It was agreed that these measures would not necessarily prevent imbalances or prevent boom-bust cycles but would allow for the build-up of buffers to weather the bust. A presentation on backtesting of countercyclical buffers in the case of US, UK and Spain showed that the use of this instrument would not only provide financial institutions with additional capital buffers but also signal the need for *further actions to build margins of safety during the boom period*. However, the need for caution in what can be expected from this instrument was noted—in the case of the Irish bank example, the bank reported very high levels of capital adequacy. Also, even if the countercyclical buffer (alone) had been utilized, it would have provided little protection given the large size of the shock and the sharp deterioration in the quality of the bank's asset.

A case was made for not using elaborate instruments applied universally (like countercyclical buffers) but rather for concentrating on sector-specific instruments that target potential

“excesses” in relevant sectors (housing, commercial real estate, credit card loans etc). As examples of such tools the following were noted: adjustment of risk weights (for commercial real estate exposures in the case of India), additional provisioning requirements, ceilings on lending (cap on commercial banks’ property sector exposures at 35 percent of total eligible assets in the case of Singapore) and tighter underwriting standards (LTV ratios and debt servicing ratio at 50% and stress testing for residential mortgages in the case of Hong Kong SAR). These experiences suggest that sector-specific tools are likely to be more effective than across-the-board tools (such as higher capital requirements or surcharges) in restraining a credit-fuelled housing bubble, especially in the context of several Asian countries where most banks are very well capitalized.

Concerns were raised that Basel 3 may fall short of addressing liability side issues relating to short-term funding in foreign currency—a key concern in Asia with increasing capital flows intermediated through the banking system. Complements to Basel rules in terms of liability side measures were discussed. These included loan to value ratios in conjunction with debt to income constraints and cap on loan to deposit ratios. The bank levy on non-core banking liabilities (financial stability contribution proposed by the IMF) was suggested as a good approach for some countries, especially those susceptible to rapid build-up in short-term foreign currency liabilities in the banking sector, with a call for further work on home-host issues and scope for circumvention.

In the context of SIFIs, the recent measures by the Swiss authorities proposed for legislation were discussed. These include two additional capital charges: (i) 8.5 percent capital buffer composed of at least 5.5% common equity. The remainder may consist of contractual contingent capital instruments (converting to common equity at a high trigger point, i.e. when the common equity ratio goes below 7%); (ii) a progressive component determined according to the size, market position and interconnectedness of the financial institution. At the status quo of the Swiss big banks, this component amounts to 6% of risk-weighted assets. The progressive component is proposed to be composed of contractual contingent capital instruments (converting to equity at a lower trigger point, i.e. when the common equity ratio goes below 5%). The authorities have also proposed a leverage ratio. Moreover, the proposal contains organizational measures. It is the responsibility of each systemically important bank to prepare an emergency plan to ensure the continuation of systemically important functions and to support orderly resolution. However, if a bank were unable to demonstrate the effectiveness of such an emergency plan, the supervisory authority would order the necessary organizational measures to be taken. Finally, the proposal comprises more rigorous liquidity requirements as well as a limitation of interconnectedness and cluster risks in the financial sector. The authorities believe that the proposed policy mix will significantly reduce the “too big to fail” problem in Switzerland.

Concerns were raised over the shift towards clearing of trades through counterparty clearing systems (CCPs). It was noted that there is a need to put in place adequate safeguards to avoid creating the next set of TBTF institutions.

Participants noted the need for a formal legal competence for central banks to be effective in prevention efforts. In this context, it was stressed that there is a need for independent access to detailed financial institution level data in particular when the central bank does not have authority for micro-prudential supervision. It was also noted that the central bank, in its capacity as the sole/lead macro-prudential authority, should be able to propose and to implement regulations for systemic risks (such as additional capital surcharges, measures targeted at SIFIs, LTVs and constraints on interbank exposures).

All participants stressed that regulation is only a part of the solution and that there needs to be much more emphasis on importance of effective supervision, in particular resolve to act under uncertainty. Also, the need for further efforts to address TBTF by strengthening resolution frameworks, both domestic and cross-border, was emphasized.

During the discussion session, several important issues were raised. These included the following:

- The role for subsidiarization in order to deal with the international dimension of TBTF (some participants thought this was difficult given the global nature of the operations of the financial institutions and that the costs were higher than benefits)
- Skepticism about the role for contingent capital instruments (shifting risks to institutional investors and possible adverse signaling implications of a conversion);
- The need for careful calibration of countercyclical capital in the context of EM countries (so as to not deter credit growth in general but to target sectors with excessive credit growth);
- The adjustment of mark-to-market valuation to counter procyclicality;
- The need to complement LTV with DTI to dampen the cycle and to protect both lenders and borrowers.

Session was concluded with a call for further analysis of different instruments, both across-the-board and sector-specific, and that the IMF should play a key role in conducting this work