"Macro-Prudential Policies: Asian Perspectives"

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Session II: Components of Macro-prudential Regulation[1]

Macro-prudential tools build on existing micro-prudential tools, but are implemented with the objective of mitigating the build-up of systemic risks and in curtailing the spillover effects across markets and institutions in the event of shocks, as well as to minimize the spillovers to the real economy. Examples of macro-prudential tools include loan-to-value and debt-to-income limits on individual loans that limit the aggregate economic exposure to economic downturns; dynamic provisioning to create buffers against rising levels of impaired assets in the downturn; caps on the loan-to-deposit ratio of banks; capital requirements that vary over the economic cycle so as to lean against the build-up of excessive bank loan growth in booms; and the imposition of bank levies on non-deposit liabilities of the banking system that moderate the use of unstable wholesale funding by banks during booms. These instruments have been an important part of the toolkit in a number of economies, particularly in Asia.

How should systemic risk associated with *individual* financial institutions be limited?

The crisis crystallized the reality that systemically important financial institutions (SIFIs) benefited from implicit government guarantees and, moving forward, the intended measures should be designed to: (i) significantly reduce the probability of their failure by strengthening their resilience; (ii) reduce the negative externalities that could arise from their failure; and (iii) improve their resolvability and ensure that essential functions for the financial system and broader economy can continue to be performed if the firm should fail. Definitions of systemic significance for an individual institution draw on concepts of size, interconnectedness, and substitutability of services. Work broadly covers the following areas:

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[1] Recent IMF analyses of these issues includes: Andritzky et al., ''Policies to Mitigate Procyclicality,'' IMF Staff Position Note 09/09 (http://www.imf.org/external/pubs/ft/spn/2009/spn0909.pdf); Carvajal et al., ''The Perimeter of Financial Regulation'' IMF Staff Position Note 09/07 (http://www.imf.org/external/pubs/ft/spn/2009/spn0907.pdf); *Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management*, 2009 (http://www.imf.org/external/np/pp/eng/2009/020409.pdf); ''A Fair and Substantial Contribution by the Financial Sector,'' 2010 Report to the G-20 (http://www.imf.org/external/np/g20/pdf/062710b.pdf); *Resolution of Cross-Border Banks: A Proposed Framework for Enhanced Coordination, 2010* (http://www.imf.org/external/np/pp/eng/2010/061110.pdf); Viñals et al., ''The Making of Good Supervision: Learning to Say No,'' IMF Staff Position Note 10/08 (http://www.imf.org/external/pubs/ft/spn/2010/spn1008.pdf).

- *Prudential requirements* – In addition to the system-wide prudential enhancement to liquidity and capital standards being developed in Basel, consideration is also being given to systemic, risk-based capital and or/liquidity surcharges. Though there are significant challenges in identifying how to design and calibrate such surcharges, these more stringent prudential norms would reflect the greater risks that SIFIs pose.

- *Systemic levies/taxes* – Another approach to discouraging the build-up of systemic risk would be to apply a levy that is linked to institutions' systemic importance, paid either into a segregated resolution fund or into general revenue. The levy could also be designed to promote financial stability by exempting Tier 1 capital or insured deposits from the tax base. The Fund's views on levies have not been universally accepted but some jurisdictions are moving ahead along these lines. Without international coordination or integration with regulatory frameworks, however, the prospect of regulatory arbitrage opens up.

- *Enhanced supervision* – More intensive and coordinated supervision of the systemically most-sensitive institutions is essential, and principles to inform such work are being developed. Ensuring that supervisors have the "will to act" may be the most the most straightforward, but most difficult, challenge of the reform agenda.

- *Resolution and resolvability* – The ability to resolve a systemic firm in crisis in an orderly manner is fundamental to reducing contagion risk. The most profound solution would be the development of effective cross-border resolution frameworks, but this cannot be delivered rapidly and may not be possible to achieve unless robust burden-sharing arrangements can be agreed. Additional tools under development include "recovery and resolution plans/living wills," which identify steps the firm should take to address contingencies and improve resolvability. Structural measures may include limiting the size or scope of a firm's activities, or requiring subsidiarization by jurisdiction or business line to lessen overall complexity.

How should procyclical tendencies and risks in the financial system be countered?

The experience of the past decade has illustrated that markets and institutions tend to behave procyclically, reflecting, at least in part, a myopia that leads participants to unduly weight recent asset price and other developments and discount the risk of a bust. Moreover, there is growing recognition that micro-prudential regulations—unless carefully designed—can also encourage this procyclical behavior. Against this background, work is underway to address this nexus in several dimensions:

- *Capital charges*: Proposals include countercyclical buffers that adjust capital requirements over the cycle by factors related to above-average growth of credit expansion; restrictions on leverage; and the capital conservation buffer. Countercyclical capital buffers are the most challenging in terms of design and cross-border application, and are likely to require a blend of transparent rules and supervisory discretion in application.

- *Contingent capital*: The Basel Committee has also launched proposals for automatic debt-equity conversion of all noncommon Tier 1 and Tier 2 capital instruments at the point of nonviability (gone concern) to ensure the loss absorbency of regulatory capital. These instruments are untested and present many issues including design of the conversion trigger, pricing, and market signaling effects. The effectiveness of these instruments in stemming the build-up of systemic risks remains to be seen.

- *Accounting and provisioning*: The introduction of expected loss (EL) provisioning, permitting provisions to be taken ahead of incurred loss, and a reconsideration of the use of mark-to-market or fair-value accounting (which can accentuate a downward spiral in valuations) may reduce procyclical dynamics. Although there is strong agreement between regulators and accounting authorities on the need to move toward EL provisioning, there is no consensus on whether fair value accounting could or should be eliminated or modified. Proponents argue that fair value is essential for market transparency, and opponents argue that it exacerbates volatility needlessly and can accelerate a crisis.

- *Limiting exposure:* Proposals to limit exposures by making margining practices more conservative and risk-based, or by imposing loan-to-value ratios (LTV) for non-wholesale portfolios, seek to protect against the immediate impact of a decline in valuation of collateral. Debt-to-income (DTI) limits on individual loans, concentration limits, and loan-to-value restrictions (often using a wider range of supervisory judgments), were probably the most commonly applied of macro-prudential tools pre-crisis, particularly in Asia during periods of rapid growth in property markets. In the period ahead, greater attention is likely to be paid by a broader range of countries on such tools to address systemic vulnerabilities.

- *Compensation practices*: With the benefit of hindsight, bonuses and other aspects of compensation within the financial sector encouraged actions by individuals and business units that were inconsistent with the safety and soundness of both individual firms and the system as a whole. In response, the FSB has recently established principles for sound compensation that aim to ensure that compensation and related governance practices do not encourage excessive risk taking.

Issues for discussion

- *Macro-prudential tools.* How do the various tools compare in terms of mitigating the build-up of risks (LTV versus DTI, systemic surcharges versus levies, etc.)? How can they be tailored to individual country circumstances? What are country experiences? What tools can be used to mitigate systemic risk build-up in the "shadows"?

- *Systemic liquidity*. Should a systemic liquidity surcharge be introduced to take into account the risks associated with wholesale funding risks? To which institutions should such a charge apply, and how should such a charge be calibrated?

- *Cross-border issues*. How can mechanisms be established to encourage cross-border cooperation, coordination, and consistency? Given the global nature of the financial system, how can countries coordinate their macro-prudential stances? What would the ideal framework for cross-border resolution of complex financial institutions look like, what are the impediments to its establishment, and what second-best approaches should be adopted in the interim?