Macro-Prudential Policies: Asian Perspectives
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Session I: The Macro-Prudential Framework

The opening session focused on the objectives of macro-prudential oversight and how these could be integrated with more traditional regulatory and macroeconomic policies, particularly monetary policy. At the outset, the participants recognized the considerable challenges faced in defining the nature and scope of macro-prudential policies, the appropriate tools to be used, and who should be responsible for deploying them. While these difficulties call for a measured approach and some humility, it was agreed that they should not paralyze policymakers into inaction and preclude careful experimentation. In particular, the recent crisis had revealed severe information and data gaps and new elements that needed to be integrated into the assessment of countries' vulnerabilities. The process would no doubt take time but it needed to start now, otherwise there was a danger of losing focus as the memory of the crisis fades.

Overall, the session issued a clarion call for developing a clearer framework for defining macro-prudential policies and how they could be conducted. Participants agreed that while the concept of systemic risks to financial stability was not new, it has nevertheless taken a long time for policymakers to accept that macro-prudential oversight was important. This reflected conceptual difficulties faced by: (1) *supervisors*, in making the leap from bottom-up to systemic approaches, and (2) *macroeconomic policymakers*, in integrating the financial sector into their policy frameworks.

Strategically, it was felt that reaching some agreement on the objectives was key. Clear objectives could in turn help better define the appropriate perimeter of macro-prudential regulation, as well as the instruments and institutional arrangements needed. In this context, objectives championed by the Fund received broad support, notably removing procylicality in credit and financial cycles; focusing on system-wide financial linkages and those between the financial system and the real economy; mitigating cross-border spillovers; and improving the supervision, regulation, and resolution of systemically important financial institutions, including those that operate in multiple jurisdictions.

In terms of policy instruments needed to achieve such objectives, many participants felt that we needed to look beyond existing tool-kits. The new Basel-III proposals, while useful, were widely viewed as incremental rather than adding the new dimension needed for adequate macro-prudential regulation of the financial sector. At the same time, it was recognized that policy tools can have spillover effects and should therefore not be pigeon-holed as serving exclusively monetary, micro-supervision or macro-prudential purposes—for instance, interest rates can affect asset prices, credit creation, capital flows, as well as risk perceptions.

Instead, a combination of tools could be better suited to address systemic risks to financial stability—in Singapore, for instance, a combination of loan-to-value ratios, transaction taxes and supply-side policies had helped the authorities to ensure a stable and sustainable property market.

Equally, there was agreement that regulations are only part of the solution and that more emphasis on effective supervision was also called for. In this context, the need to insist on better and more complete disclosure by large financial institutions on their exposures and linkages was also deemed important. On the other hand, there was a shared view that the risks of over-regulating financial sectors and creating overly-complex new frameworks in the false pursuit of immutable financial stability needed to be guarded against. In emerging markets, where the financial systems are incomplete, for instance, a strict rules-based approach to implementing counter-cyclical capital buffers was viewed by some as having an adverse impact on needed investments in productive capacity, without having sufficient effect on property market dynamics."

On the question of who should be given primary responsibility for macro-prudential policies, there was broad agreement that they need to be nested into the broader macroeconomic framework, with monetary policy ultimately at the heart of the matter. In particular, any perceived conflict between price stability and financial stability was rejected as false—indeed, there was some support for monetary policy responding more symmetrically to asset prices and the financial cycle. Therefore, the value of divorcing the two functions entirely was questionable. Instead, ensuring a single agency (such as the central bank) or at least very close cooperation between multiple concerned agencies was deemed desirable. The Reserve Bank of New Zealand, for instance, has dual mandates covering both price and financial stability.

If central banks are charged with this responsibility, however, their mandates and operational frameworks would need to be recast and they would need to attract the best human capital from a variety of fields, including both macroeconomics and the financial sector. In this context, a key challenge would be to preserve monetary policy credibility and independence while ensuring some form of accountability. Overall, it was acknowledged that there was no one-size-fits all approach and that countries would benefit from sharing their experiences with diverse strategies and institutional arrangements, including financial stability oversight committees. In the United States, for example, almost all the regulators and the Treasury have been assigned new powers to safeguard financial stability. Indeed, the Federal Reserve has been cautious about taking on new responsibilities and providing any firm guarantees of being able to deliver on what are still relatively nebulous concepts of macro-prudential stability, particularly since it is wary of losing the credibility it has built up over many decades.

During the discussions, participants acknowledged that for macro-prudential policies to be successful and prevent regulatory arbitrage, they would need an effective multilateral context. Here, institutions such as the BIS, the FSB, the G-20, and the IMF could help identify systemic cross-border risks to macroeconomic and financial stability. Some participants also felt that these bodies could help lay down the basic principles for developing global macro-prudential policies, which could then be tailored to individual country circumstances. In addition, participants concurred that international cooperation would be needed to make progress on several unfinished aspects of the financial stability and reform agenda, particularly with regard to supervision and resolution mechanisms, including a cross-border coordination framework.

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

Session III: Macro-prudential measures and capital flows

This session was concerned with the macro-prudential toolkit for managing capital inflows in a manner that preserves financial and macro stability. A broader context related to the need to anticipate and counteract wider risks to financial stability stemming from credit and asset price cycles. These were particularly thorny issues because, while the overall toolkit for macro-financial stability was well known, the policy levers were typically widely dispersed across institutions within national jurisdictions, with corresponding implications for responsibility and accountability. Although there was a wide spectrum of arrangements, they were clearly not all equally effective in anchoring expectations of market participants and the broad public that financial stability would be the overriding objective when inevitable conflicts arose. A key issue, therefore, was to determine whether optimal institutional configurations could be established that respect local governance expectations, and how these configurations might vary with a variety of country characteristics.

Participants discussed the broader context of surging capital inflows to the Asian region, and how policy makers saw the challenges—which included both macro-economic (overheating, inflation) and financial stability challenges (surging credit and asset prices, and the risk of banking and currency crisis). Though periods of surging capital inflows were nothing new for emerging markets, today's global context was different, as it reflected the extremely easy monetary conditions in the countries at the epicenter of the global crisis, which were pushing liquidity toward emerging markets (search for yield and carry trades). As such, the capital flow cycle was due to forces beyond the control of emerging markets and, with global markets more integrated than ever before, the consequences of boom turning to bust would be correspondingly more serious for emerging market countries.

Participants considered that a flexible deployment of all the available policy instruments was necessary to address the challenges posed by surging inflows. The relevant instruments included monetary and exchange rate policy, fiscal policy, and of course macro-prudential policy in which capital account management may have a role to play. Structural reforms to improve the resilience of the financial system and its ability to intermediate inflows effectively were also essential to minimize vulnerabilities.

The Thai experience was viewed as combining a number of these elements, including effective use of selected macro-prudential tools (e.g., regulations to curb the rise in real estate prices, especially for high-end condominiums; tightening of rules on credit cards and personal loans) to supplement monetary policy in reducing the risks of excessive credit and overheating, and careful communication to the public of the role of the different measures and the distinctions between macro-prudential tools and capital account management regulations (e.g., the recent steps to equalize the tax treatment of fixed income instruments between residents and nonresidents). Broader efforts to improve monitoring and identify tipping points were essential and were being implemented in Thailand in the context of its enhanced macro surveillance system of key economic sectors. The challenges for Thailand and other emerging markets were greater now than in the past given monetary policy divergences across the globe, which raised the issue of potential gains from international policy coordination to reduce adverse spillovers for emerging markets (and of a multilateral approach to resolving the problems).

Other country representatives stressed the need to achieve resilience by strengthening domestic financial markets and infrastructure (creating an "enabling environment" for capital flows). This would reduce the need for other measures, including capital controls.

Participants were of the view that the best protection against the vagaries of a possible boom-bust cycle in capital flows was a robust domestic financial sector. This was especially the case for flows driven by purely financial factors rather than a demand for real investment capital in the domestic economy. Another key issue, some participants considered, was of potential nonlinearities in the response of foreign investors to the imposition of measures that restricted inflows. Given the integration of global markets, investors' decisions could be quite abrupt, and jurisdictions that were seen as excessively risky could wind up starved of international capital even for relatively small changes in the rules that destabilized expectations. Country representatives stressed the progress that had been made across the region in strengthening the financial sector's resilience to adverse shocks, including as evidenced by stress scenarios described in recent FSAP or FSAP updates. It was important to recognize how difficult it was, for a small emerging market economy that was open to foreign capital, to "choose" or "tilt" the composition of inflows toward a safer structure. Investors had lots of choices, and sometimes less desirable flows were a necessary evil alongside more desirable flows that benefited the real economy. In that regard, shock-proofing the economy to a withdrawal of hot money was the best defense.

Participants discussed the capital account regime in China. It was noted that the de facto regime was considerably more liberal than de jure and, from the point of view of market participants, the restrictions were not seen as having a huge impact. The key remaining restrictions were on portfolio investment in China and foreign borrowing by Chinese enterprises (limits on foreign-funded enterprises were much less restrictive).

Participants were of the view that the destabilizing impact of the boom bust cycle in capital flows could be more acute in the present environment because highly stimulative monetary policies in advanced economies was likely to push even more funds to the emerging market countries, risking an even bigger outflow when conditions in the advanced economies eventually normalized. As a result, exchange rate overshooting—given the "original sin" in many emerging market countries—had the potential to cause real problems for financial stability when flows reversed and local currencies depreciated. Participants felt that this situation meant that controls on inflows were likely to be justified as a component of the toolkit to manage the risks to financial stability associated with surges, under certain conditions, and they considered that the taxonomy of conditions put forward in the recent IMF staff policy note seemed reasonable and objective.

This being said, over the medium term, it made sense for emerging countries like China to strive for greater liberalization of the capital account, to improve the ability of firms and households to engage in inter-temporal trade and reap the benefits of financial globalization. Capital account restrictions were viewed as adversely affecting “the good guys”, that is firms that could benefit from greater financing to fund profitable investment domestically. Administrative complexity of the restrictions tends to be cumbersome, and could result in corruption and rent seeking behavior. In addition, over time, restrictions tended to lose effectiveness due to circumvention. Reflecting these realities, China would move over time to full capital account convertibility, making the environment fully transparent for both businesses and households, and administrative measures would gradually give way to more transparent price-based measures.

A wide-ranging discussion among participants revealed a spectrum of views regarding how to design capital controls, with some favoring broad restrictions against flows that had little tangible benefit for the real economy (that is all flows except FDI), and others emphasizing the need for harmonization of approaches across countries to avoid flows being displaced to jurisdictions that were less able to absorb them. Some participants noted that circumvention was not in itself an argument that controls were of little benefit, since if the result was reduced intermediation through the domestic banking system (even if inflows came in through other channels), the vulnerability of the domestic economy was reduced.

Participants also engaged on the issue of sequencing, and stressed the dilemma that capacity to absorb inflows improved with the development of the domestic financial sector, but such development was itself facilitated by greater openness to foreign capital.

Session IV: The Changing role of the central bank

The roundtable focused on the role of the central banks in the aftermath of the crisis. The issues that received particular attention included aspects of central banking that proved to be strengths during the crisis and the need for recasting of mandates and operational frameworks to better address systemic risks.

The participants noted that the provision of large amounts of liquidity, including by modifying liquidity provision arrangements to better meet exceptional needs and/or establishing new facilities to alleviate liquidity shortfalls in specific markets, demonstrated the flexibility of central banks and their legal frameworks in exceptional circumstances.

It was noted that despite the massive easing of monetary policy stances and, in some cases, large movements in exchange rates, inflation expectations remained stable in most advanced economies. The participants emphasized the credibility that the central banks have built over the past two decades allowed them to respond forcefully to the near-term challenges posed by the financial crisis and the slump in activity, without undermining public confidence in the commitment to longer-term inflation objectives (although this is seen as a limitation for some EM countries as they have not yet established the same degree of credibility). In this context, the participants noted the importance of preserving the independence of central banks, in particular in terms of conducting their price stability mandate. It was also noted that fiscal consolidation in some countries will be a challenge for monetary policy given the limited room currently available for monetary policy to provide offsetting support for economic activity, and because unsustainable fiscal positions could put at risk the credibility of monetary policies.

Participants agreed that dedicated governance arrangements are needed to ensure monetary policy independence. The key challenge will be to balance this with the macro-prudential mandate which cannot be conducted in an independent manner (due to potential implications of financial instability for public purse). Where monetary policy is institutionally separate from prudential regulation or supervision, more complex institutional arrangements will be needed to ensure that the central bank works with and has an appropriate degree of influence over policies conducted by other agencies, to ensure that the agencies involved avoid conflicting policy actions and that systemic stability is appropriately accounted for. It was noted that in some countries, this has led to the establishment of financial stability oversight committees that bring together relevant agencies, and the challenge will be to ensure these are equipped to take timely action in response to emerging vulnerabilities. It was stressed that the central bank should have a lead role given its institutional strength, credibility, human capital and the continuity over political cycles.

Going forward, the participants agreed that monetary policy frameworks will need to be modified to take into account financial developments and vulnerabilities in setting interest rates and other policies. The lack of analytical frameworks to support a macro-financial focus for policy—including better bases for monitoring and analyzing the role of financial systems in the transmission mechanism, measurement of systemic risks and stress tests—was seen as an important impediment. However, it was stressed that shortcuts and rules of thumb need to be applied in the interim as models are developed.

Some participants raised concerns regarding an explicit financial stability objective in addition to the monetary policy mandate as this could undermine the central bank's credibility and independence, especially in the absence of additional macro-prudential instruments. They also indicated that central banks have in the past used monetary policy tools on specific occasions to maintain financial stability. In this context, they emphasized the need for strengthening the capacity of central banks to monitor and analyze macro-financial imbalances and risks, and possibly expanding the range of indicators that feed into policy decision making to include asset prices and loan growth.

The specific challenges for Asian countries were discussed. A distinctive feature of the Asian, and in particular, the Japanese financial system, is that bank lending plays a dominant role in financial intermediation. It was stressed that the real economy could be adversely affected if the risk-taking capacity of the banking sector is seriously damaged. In this context, during the recent crisis, the Japanese authorities reintroduced the stock purchasing program (first implemented in 2002) and adopted a facility to provide subordinated loans to banks as temporary counter-cyclical measures. The Bank of Japan has an explicit financial stability mandate.

It was also noted that although prudential supervision is conducted by the Japanese FSA, Bank of Japan continues to conduct on-site examination and off-site monitoring over a wide range of individual financial institutions, including securities firms. The off-site monitoring pays particular attention to liquidity risks, including daily assessment of the liquidity position of individual institutions. It was stressed that quarterly-disclosed balance sheet figures are not sufficient for effective monitoring and that the information obtained through the Bank of Japan's on-site examination and off-site monitoring has enabled the Bank to respond quickly to the liquidity drain in the recent crisis.

It was suggested that the policy horizon for achieving the inflation objective should be lengthened to facilitate taking financial stability concerns into account. However, several participants noted that persistent deviations of inflation should be avoided as this would dilute policy accountability and fuel uncertainty about the long-term commitment to price stability.

The discussion then focused on the aspects of liquidity provision by central banks to address problems in specific markets and institutions. The experiences of several countries to make liquidity management frameworks more flexible and broader to increase the crisis options were discussed. The measures used included higher reserve requirements, a broader range of counterparties, modifications to collateral requirements, measures to reduce the stigma attached to borrowing, and additional liquidity absorbing tools.

The participants stressed the need to better understand macro-financial interactions, and build the key features of these interactions into their standard analytical and forecasting frameworks for monetary policy. In particular, there is a need to analyze transmission mechanisms and their effects on financial innovation, including the growth of the shadow banking sector.

Empirical analysis for Korea was presented showing the growth of non-core liabilities by the financial sector under an interest-rate oriented monetary policy framework. This induced massive interbank transactions raising financial stability issues. The policy conclusion was that the central bank needs to take into account the endogeneity of asset prices and credit cycles when formulating its monetary policy.

The challenges of low interest rates and unconventional monetary operations conducted by most of the advanced country central banks in terms of large capital inflows to many EM countries, especially in Asia, were also discussed. Central banks are using a variety of tools to limit the impact on exchange rates and domestic financial systems, including large-scale foreign exchange market intervention, foreign exchange liquidity support, and regulatory measures. The key concern in the medium term is the potential reversal of flows as expansionary policies are phased out. The long-term concern is the ability of EM countries to continue to attract capital flows due to potential crowding-out by MM countries with high public debt.

The Korean experience in mitigating capital flow volatility was presented—widening the inflation target band from 3% +/- 0.5% to 3% +/- 1%; strengthening foreign currency liquidity ratio requirement; increasing the eligible liquid asset requirement; limits on net fx derivatives positions of banks and caps on fx bank loans.

The need for greater international cooperation among central banks and governments was emphasized to address the challenges posed by global imbalances.

Finally, it was noted that the global regulatory framework should have sufficient flexibility to allow for regional and functional heterogeneity. There was a call for balancing rules versus discretion in financial regulation and making full use of the Pillar II of Basel Accord.

The use of prudential liquidity policy as a macro-prudential tool—liquid asset ratio and core funding ratio to raise bank cost of funds relative to money market rates at the same time as reducing the reliance of banks on volatile short term wholesale funding sources. It was noted that this can shift monetary policy pressure towards domestic demand, away from the traded goods sector, by reducing carry trade pressure on the exchange rate.