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Financial System Stability Framework: The Emerging Economies Experience

Mudasiru. A. Adegbite *

I. Introduction

The 2007- 2008 global financial crisis and the resultant recession led to a profound re- examination of macroeconomic policy and financial regulation. The focus on financial stability had triggered regulatory reforms such as the Basel III accord which envisions more stringent capital regulation and other prudential tools. Macro-prudential policy was motivated by the fact that micro-prudential regulation is necessary but not sufficient to deal with systemic risk. Micro-prudential regulation as amplified in Basel I and II capital accords tends to view financial institutions in isolation and aims mainly to ensure that each is individually solvent. Beyond traditional micro-prudential regulation, the 2007-2008 crisis has led to a new focus on macro-prudential policy to address systemic risk and its consequences on the economy (Bernanke, 2009).

Macro-prudential analysis gained its prominence since the economic meltdown. It is different from traditional macroeconomic policies but addresses issues of financial stability in a more holistic manner. Prior to the global financial crisis, the primary purpose of traditional market policy was price stability with the belief that this would eventually lead to financial stability. Also, financial supervision had focused more on individual financial institutions with the expectation that this would guarantee the stability of the entire financial system. Since the crisis, it is now clear that financial stability would be difficult to achieve based on the traditional monetary and micro-prudential policies. The macro-prudential analysis is, therefore, aimed at preventing the accumulation of systemic risk within the financial system and the need to promptly address issues relating to the systems' stability.

The objective of this paper is to review the macro-prudential framework, its tools and its nexus with financial stability. The experience of the emerging market economies in

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designing macro prudential framework would be highlighted. The remaining sections of the paper are divided into six. Following this introduction, section 2 contrasts macro-prudential policy issues against micro-prudential issues. Section 3 discusses macro-prudential framework in different jurisdictions, particularly in the emerging market economies vis-à-vis developed economies. Section 4 discusses the experience of some emerging economies in the implementation of macro-prudential policies, while section 5 reviews major benefits of macro-prudential policy analysis. Section 6 presents the challenges and prospects of macro-prudential analysis in relation to its linkage with the traditional monetary and fiscal policies. Section 7 concludes the paper.

II. Macro-Prudential Vs. Micro-Prudential Policy Analysis

Macro-prudential policy is underlined by three main elements. These are:

- to limit systemic risk;
- to focus on the financial system as a whole as opposed to singular components; and
- to adopt instruments and associated governance including prudential tools calibrated to target the sources of systemic risk.

The framework seeks to address broad issues which include:

- identification and monitoring of systemic risk;
- identification and calibration of instruments for macro-prudential purposes-e.g. introduction of counter-cyclical capital buffers, attention to systemically important institutions, etc;
- building of institutional and governance structures in the domestic and regional context; and
- focus on financial stability in the domestic and regional context.

II.1 Micro-Prudential Policy

Micro-prudential policy on the other hand focuses on:

- Individual institution's health and soundness;
- Individual institution's risk factors including operational risks;
- Use of traditional supervisory and regulatory tools;
- Price stability within the domestic economy; and
- Issues of inter-connectedness and contagion.

It is important to emphasise that effective macro-prudential framework requires institutional arrangements and governance structure that allow for effective

interaction among policy makers on policy choices that impact on systemic risk, resolution of conflicts among policy objectives and instruments as well as and deployment of tools to limit systemic risk. Furthermore, many jurisdictions still lack specific institutional arrangements for the conduct of macro-prudential policy and will require time to fine-tune existing structures to the requirements of macro-prudential policy framework.

III. Macro-Prudential Policy Tools, Framework and Financial Stability.

Macro-prudential policy tools had relied on the traditional micro-prudential tools of capital, liquidity and leverage ratios but with adjustments to contain potential sources of systemic risk such as pro-cyclicality and interconnectedness. This calls for the development and use of additional policy instruments as recommended in both Basel II and III, especially issues of capital buffers and conscious efforts of preventing financial crisis. This would extend beyond the traditional role of a central bank. The use of capital buffers and reserve requirements by central banks would provide effective tools for controlling systemic liquidity if their targets are expanded from bank deposits to liabilities of other financial institutions. The effectiveness of monetary and fiscal policies when regional policy coordination is sub-optimal remains to be adequately understood. The experience of the European Union countries had highlighted the dangers in ineffective macro-and micro-prudential policy outcomes and ineffective banking supervision. In the Economic Community of West African States (ECOWAS) block, the banking environment has been characterised by uncoordinated supervision amongst relevant agencies. In Nigeria, there is growing importance of the Financial Sector Regulation Coordinating Committee (FSRCC) in the area of policy coordination to prevent regulatory arbitrage even in the absence of formal macro prudential policy arrangement to drive the process. There is therefore an increasing need for the Central Bank of Nigeria, Ministry of Finance, National Planning Commission and other members of FSRCC to provide clear guidelines for a formal Committee on macro-prudential policy which could be independent of the Central Bank. Whatever the framework that is adopted, however, the Central Bank of Nigeria will have to play a key role in assessing systemic risks, as it has the expertise and analytical capacity to undertake such a task.

Macro-prudential framework institutional arrangements in other jurisdictions:

As a result of the economic crisis in major economies, several developed countries have in recent times established separate bodies for macro-prudential policy as distinct from micro-prudential supervisory arrangements. This is aimed at

strengthening oversight of systemically important financial institutions and correcting the global market failures that abounded during the period.

Three distinct types of frameworks are currently in place:

- Type 1: Countries in this category have an integrated micro-prudential supervisory framework with a macro-prudential committee under the aegis of the Central Bank. The United Kingdom and Belgium are examples of this arrangement where the Governors of the Bank of England and the National Bank of Belgium chair the committees
- Type 2: These set of countries have a diversified micro-prudential supervision framework and independent macro prudential policy committee chaired by the political head in the Ministry of Finance or the Treasury. Examples include the United States of America and the 27 countries in the European Union (EU).
- Type 3: These consist of countries with integrated micro-prudential supervisary arrangements and independent macro-prudential committee where chairmanship of the committee is rotated amongst the members including the Central Bank, Treasury and the supervisory authority. Hungary is an example in this arrangement.

The merits and demerits of the arrangement where chairmanship is rotational or where the central bank drives the committee as the chair are varied. The advantages of a Committee chaired by the central bank include:

- faster decision making process;
- clearer lines of responsibility; and
- political and fiscal neutrality.

In some cases, independent committees could offer a better option for the following reasons:

- better focus on financial stability;
- protection of central bank credibility; and
- better financial and policy accountability.

The emerging economies have keyed into the arrangement in their various variants. In some cases, there are integrated micro-prudential supervisory frameworks in place and independent macro-prudential committees where the central banks play the major role of driving macro-prudential policy. In other countries including Nigeria, the arrangement in place consists of diversified micro-prudential supervisory arrangement but with central bank and the treasury driving the process of an

emerging macro prudential policy framework. While the process in Nigeria is still emerging, it is important to note thot the issue of financial stability has assumed a prominent focus in public policy formulation and the Central Bank of Nigerio remains a key element in this arrangement.

IV. Experience of Some Emerging Economies in Macro-Prudential Policy Framework Implementation

IV.1 IMF Financial Stability and Macro-Prudential Survey

In a survey conducted by the Manetary and Capital Market Department of the International Monetary Fund (IMF) in 2010, aimed at assessing the international experience with financial stability and the evolving macro-prudential framework, three areas were identified for study. These included the institutional setup for mocro-prudential policy, the analytical approach to systematic risk monitoring ond the macro prudential toolkit. The survey covered 63 countries and European Central Bank (ECB) including all countries in the G.20 and those subject to mandatory Financial Sector Assessment Programs (FSAPs)

Major findings of the survey were:

1. Macro-prudential policy is becoming an overarching public policy in the wake of the global financial crisis;
2. Conduct of macro-prudential policy is a multi-agency consensus process;
3. A voriety of indicators and quantitative tools are used for systemic risk identification, monitoring and assessment; and
4. Macro-prudential policy is viewed as having a wide range of instruments. The tool kit contains most notably, prudentiol and monetary tools as well as fiscal and competition policies.

IV.2 Some Specific Country Experiences

IV.2.1 Nigeria

Nigeria's mocro-prudential policy framework is noscent. The initial steps involved increased policy coordinotion through the activities of the financial sector regulation coordinating committee chaired by the CBN. Also the Bank had facilitated the publication of half-yearly finoncial stability report, though the legislation on financial stability as a key objective in the central bank Act has not been ratified. A directorate for financial stability within the central bank had since been creoted to drive the necessary policy initiatives for macro prudential policy framework and financial stability os a key policy objective through the establishment of financial system stability committee.

IV.2.2 South Korea

Huo-kyu Rhu, in a seminar paper that reviewed the progress of Macro-Prudential Policy Framework in South Korea noted that "there has not yet been a full-blown discussion of the macro-prudential policy framework, rather we are just taking steps to improve the current policy coordination framework". He stated that amongst G-20 member countries only South Korea and Australia do not state "financial stability" as an explicit objective in their central banks Acts.

IV.2.3 South Africa

The Reserve Bank of South Africa has a full-fledged Financial Stability Department which coordinates activities relating to macro-prudential policy analysis. Macro-prudential analysis has been used in detecting vulnerabilities in the financial system. This involves, amongst other things, the identification of financial soundness indicators (FSIs) and the methods used to analyse them. The main method of identifying macro-prudential indicators within the South African context are outlined as ensuring compliance with international best practice, making use of economic theories and taking into account the linkages between various sectors of the economy. The analytical methods include monitoring trends of macro-prudential indicators and developing models to assist in the analysis. Stress testing remained one of the most popular modeling techniques used by most institutions.

IV.2.4 Thailand

The Bank of Thailand coordinates matters relating to macro-prudential policy. In a keynote address, Watanagase (2004), at a workshop on Macro-prudential policy framework, opined that "no institutional framework of macro-prudential policy fits all countries alike, yet we know now that central banks should play a leading role for its expertise- albeit, it is still important to involve the Ministry of Finance in a careful manner". This further underscores the need for inter-agency cooperation in operationalising an effective macro-prudential policy framework.

V. Benefits of Macro-Prudential Policy

In most jurisdictions macro-prudential policy framework has gained acceptance amongst policy makers, especially the managers of the economy. The framework offers some distinct benefits when compared with micro-prudential framework and other policies. These benefits include the following:

- **Issues of systemic risk and financial stability**

  Apart from its comprehensiveness, macro-prudential policy analysis addresses the systemic issues rather than individual institutions, thus, providing

a holistic overview of the entire financial system. The focus on financial stability rather than the solvency of individual institutions is a distinct advantage. Financial stability provides a more realistic measure of policy effectiveness rather than price stability ar institutional solvency.

- **Policy consistency**
  The grawing awareness amongst public policy advisors for policy consistency and coordinotion underscores the benefit af macro prudential policy analysis where inter-agencies coaperation ond support are key elements af its implementation.

- **Prevention of market failures**
  The use of macro-prudential policy fromework could help in preventing morket failures and finoncial crisis. The institutional arrangements in macro-prudential policy analysis provided safeguards for appraising the finonciol system in a more robust monner by employing economic modeling which relied on a wide range of data to identify the systemic risks and the factors responsible for these risks os well as measures to prevent or ameliorate the risks.

- **Credible alternative to monetary and fiscal policiesMacro-prudential policy framework provides credible alternative to monetary and fiscal policies.** Monetary and fiscal policies are directed at addressing issues of interest rates, credit, taxes and subsidies, among others, whereas macro-prudential policy takes a broader perspective in addressing issues of financial stability, systemic risks, interactions with the institutions and effective coordination to achieve a comman objective. Macro-prudential policy analysis without undermining the relevance of traditional economic policies provides additional tools to policy-makers for effective and proactive management of the economy.

VI. Challenges and Prospects of Macro-Prudential Policy Framework

VI.1 Challenges

As macro-prudential policy analysis is gaining traction over micro-prudential analysis, there are some challenges facing the full scale implementation of the policy in most jurisdictions. These challenges include the fallowing:

- **Systemic risk identification**
  The identification of systemic risk is a nascent field. No common paradigm exists yet. Applied research is required in this area to ensure effective collection and analysis of economic and financial data on a domestic and global scale.

- **Macro-prudential tools and their effectiveness**
  Macro-prudential tools will need to be tested in different circumstances and their performance evaluated against expectations. In the emerging markets, the progress in implementing Basel II and III had been slow and this needs to be addressed to enhance policy effectiveness.

- **Poor governance and institutional arrangements**
  Most jurisdictions still lack effective governance and institutional structures for the implementation of macro prudential policies. There are potential conflicts between the new macro-prudential policy framework and the traditional monetary and fiscal policies. Also political influence could be an issue where the Treasury and Ministry of Finance are saddled with the task of driving the macro-prudential framework implementation.

- **Data collection and data integrity**
  Collection of accurate data remained a challenge especially in emerging economies where adequate and comprehensive data collection mechanisms are still problematic. Also, data integrity issues emanating from quality and quantity of information in economic and financial statistics, could adversely impact on the performance and outcome of macro-prudential policy analysis. For developed economies, the challenge of data overload could affect focus on key elements that influence systemic risk and the overall effectiveness of macro-prudential analysis.

VI.2 Prospects

Macro-prudential policy is assuming a prominent position in public policy formulation considering its focus on financial system stability. The prospects of an integrated policy framework that would address issues of financial stability in a more comprehensive manner looks bright given the growing awareness of many countries in the establishment of appropriate institutional arrangements for macro-prudential policy. For the fact that the key economic and financial players in the economy agree to work together to ensure policy consistency, lends credence to growing relevance of

macro-prudential policy framework. The slow progress in the implementation of Basel II and III capital accords in most emerging economies notwithstanding with appropriate incentives, macro-prudential policy should enhance the overall policy environment and provide appropriate response to issues of financial crisis in both emerging and developed economies.

VII. Conclusion

The importance of macro-prudential policy framework and its usefulness in addressing financial stability is increasingly manifest. Also, the inter-agencies cooperation for the achievements of effective policy outcomes can no more be neglected. While the use of macro-prudential policy framework is still evolving in most emerging economies, lessons from matured markets are central to policy formulation and implementation in the emerging economies. The need for further study on the effectiveness of macro-prudential policy in addressing systemic risks and ultimately ensuring financial stability should be given adequate priority. This will help to sustain the current achievement and extend the frontier of knowledge in public policy formulation.

The contemporary issues of systemic risk analysis, the strict capital requirements including capital buffers in Basel III and the establishment of strong institutional arrangements are key critical success factors in implementing effective macro-prudential policy both at individual country and regional levels. Emerging economies also needed to focus strategically on systemically important banking institutions as well as other components of the financial system in order to properly identify the sources of systemic risk and the actions to be taken to mitigate these risks. There is an urgent need to properly articulate action plans in emerging economies to address issues relating to Basel III capital accord for its effective implementation before the 2019 deadline.

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