Opening Remarks

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It is a great pleasure to welcome all of you on behalf of the Fund at the second day of the Annual International Seminar on Policy Challenges for the Financial Sector, jointly organized by the Federal Reserve Board, the World Bank, and the International Monetary Fund. We are pleased to have with us distinguished participants from 75 countries, representing 83 supervisory agencies and central banks.

This is the eleventh edition of this seminar, and I am glad to notice that many of you are returning participants. The fact that you are again with us today shows that we have been able to draw your attention to various issues related to financial markets supervision, and that this is a useful forum for discussing high-priority items on the national and international policy agenda.

This year’s seminar is no exception: our ambitious agenda focuses on an issue that is highly relevant for all of us—systemic risk. In particular, the seminar examines the multiple facets of systemic risk, as well as the policy instruments aimed at safeguarding the stability of the financial system as a whole.

The financial crisis revealed major shortcomings in the financial sector supervisory processes. First, the supervision of individual financial institutions – the “trees” - did not have the intrusiveness and intensity necessary to recognize and address growing risks that contributed to the financial crisis. Second, we also failed to grasp the nature of this financial “ecosystem”, where distress or damage of one component may have a significant impact on the whole system, and where the total risk of the system is greater than the sum of individual risks.

Based on an examination of lessons from the crisis, we have identified at the Fund key elements of good supervision—we believe good supervision should be intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive. To achieve this perfect combination, the “ability” to supervise—which requires appropriate resources, authority, organization, and constructive working relationships with other agencies—must be complemented by the “will” to act.
However, strong and effective supervision of the “trees” is a necessary, but not a sufficient condition for ensuring financial stability. Therefore, a higher level perspective on systemic risks is necessary, which would enable us to see the “forest” and improve our understanding of the intricate web of connections between financial institutions, financial markets, and the macro-economy.

This higher-level perspective is now being referred to as macroprudential policy. There is broad international consensus on the importance of developing a macroprudential framework, which became a priority on the G20 policy agenda. However, the analytical underpinnings are still in their infancy, and many challenges lie ahead of us.

Many policymakers are already grappling with this issue, both at the conceptual level and in practical terms. A recent IMF survey (December 2010) shows that authorities in many countries are exploring the appropriate institutional infrastructure for macroprudential policy; and that the use of macroprudential instruments is becoming increasingly common. Countries are also actively engaged in designing new macroprudential instruments in international fora, such as the Basel Committee for Banking Supervision.

The IMF takes a strong interest in these developments, not least because we think that effective macroprudential policy frameworks can make a strong contribution to crisis prevention in our member countries. The G-20 has asked the IMF to further develop the elements of effective macroprudential frameworks, in close collaboration with the Financial Stability Board and the Bank for International Settlements. As part of these efforts, we have recently laid out our thinking in an IMF policy paper, published in April. We are also working with our colleagues in Basel on a progress report to the G-20, due later this year.

Our recent paper on macroprudential policy is not intended to reach definitive conclusions, because we recognize that more work is needed to develop a
We believe that macroprudential policy should be based on three pillars:

- governance arrangements
- policy instruments, and
- coordination with other policies.

Let me provide some highlights of our thinking in each of these areas …

1. Effective governance arrangements

Macroprudential policy involves managing a tail risk—the benefit of taking action is uncertain and only apparent in the long run, while the costs will often be highly visible immediately. This can create a bias in favor of inaction, or insufficiently forceful action, especially in the face of strong industry lobbying.

Taking away the punch bowl just as the party gets going has never been easy in any area of public policy, and macroprudential measures are certainly not an exception to this rule. It is, therefore, very important that governance arrangements strengthen policymakers’ ability and willingness to act.

This means that those who conduct macroprudential policy need to have clear mandates and rulemaking powers, so as to enhance their accountability and reduce the risk of political pressure.

In setting the mandate of macroprudential authorities, we need to be clear as to what macroprudential policy actually is; what it is meant to achieve; and what it is not designed to do.
In particular, macroprudential policy should focus on **risks arising primarily within the financial system, or amplified by the financial system**. It would be wrong to use it to address risks associated with macroeconomic imbalances and shocks, or inappropriate macroeconomic or structural policies—for which the first line of defense should be adjustments in macroeconomic policies.

At the same time, macroprudential policy is **no substitute for robust prudential policies** of the traditional kind, which primarily aim at ensuring the solidity of individual financial institutions.

Macroprudential authorities will need to have **access to information and analytical capability** to identify systemic risks in a timely manner and deploy adequate instruments to contain such risks.

Because of the dynamic nature of financial systems, macroprudential policy requires continuous monitoring of a broad set of information—including on firms and activities that might be outside of the perimeter of regulation. Macroprudential policy also requires identifying systemically important financial institutions (SIFIs), markets, and instruments. Here, **data gaps** are an important constraint—a challenge that is being tackled at the international level through the combined efforts of the IMF, FSB, and BIS.

Further progress is also needed in **refining models** and forward-looking measures of systemic risk, and **improved cooperation** will be needed in sharing information among relevant authorities. Finally, we should also strive to complement quantitative tools with more **qualitative assessments**, including supervisory judgment and market intelligence.

**The choice of the specific institutional arrangements for macroprudential policy** needs to reflect local conditions. In Europe, for example, we have recently seen the launch of the European Systemic Risk Board and various national institutional arrangements, such as the Financial Policy Committee in the UK, and the Financial Regulation and Systemic Risk Council in France. In the US, the Financial Stability Oversight Council has been established. Moreover, the impetus for institutional reform has not been limited to those advanced countries that have been hardest hit by the crisis. A number of emerging market economies, such as Malaysia and Mexico, have made, or are
in the process of making, changes to their institutional framework for financial stability.

Some key features of the institutional arrangements for macroprudential policy are already emerging.

One is that central banks should play a prominent role, given their expertise in monitoring macroeconomic and financial market developments, and their existing roles in monetary policy and payment systems. This analytical expertise can help achieve greater clarity about the benefits and costs of macroprudential policies. They also have strong institutional incentives to ensure that macroprudential policies are effective—because if they are not, central banks will have to take costly corrective measures.

In addition to the central bank, the regulatory and supervisory agencies need to be involved, most obviously when they retain operational authority over macroprudential instruments. The involvement of finance ministries has its pros and cons: the main pros are the ease of integration of fiscal policy and of discussion of legislative changes that may be required to mitigate systemic risks. The key counter-argument is the reduced degree of independence from the political process.

Questions remain regarding the decision-making process within multi-agency macroprudential councils and the best arrangements for ensuring accountability for implementing actions.

The next step in cementing the institutional setup is to equip the macroprudential authorities with …

2. A set of instruments for conducting macroprudential policy

Mirroring the complexity of systemic risk, the set of macroprudential policy tools is likely to be wide in scope. We agree today that the macroprudential tools should enhance policymakers’ ability to cope with two interrelated dimensions of systemic risk:
1) **The time dimension, or cyclical dimension**, which includes risks associated with swings in credit and liquidity cycles, driven by pro-cyclical forces such as leverage and herding behavior by financial institutions, non-financial firms, and households; and

2) **The cross-sectional dimension**, which focuses on the concentration of risk in certain financial institutions and markets that are highly interconnected within, and across, national borders.

Some key tools are currently being developed to specifically address systemic risk—such as countercyclical bank capital charges that lean against the economic cycle, or systemic capital surcharges that grow as the systemic impact of individual financial institutions increases.

There is also a broad range of tools that has already been used in some countries—mostly traditional prudential tools adjusted specifically to address the build-up of systemic risk. Some countries have sought to address risks in their real estate markets by putting limits on Loan-to-Value, Debt-to-Income, and Loan-to-Income ratios (China, Hong Kong, Poland, Serbia, Singapore, and South Korea). Others have deployed time-varying caps on credit or credit growth (aggregate or sectoral) to constrain credit during booms, and sustain it during busts (Serbia and Malaysia). Recent structural measures to address risk concentrations and interconnectedness include the “Volcker-rule”, which would create a ban on proprietary trading for systemically important U.S. banks; and proposals in the European Union to restrict short selling and limit the use of certain derivatives in the event of a serious threat to financial stability.

**How should these tools be used?** One key issue is whether we should use rules, discretion, or a combination of both. Rules would help overcome the bias for inaction that is likely to arise. But some form of discretion is also needed to help adjust policies to a financial sector that evolves rapidly, and where the specific sources of systemic risk are subject to change. Therefore, a combination of both approaches may eventually emerge as the sensible choice—incorporating more rules than is the case for monetary policy; but leaving scope for some discretion to adjust to a dynamically evolving financial sector.
Let me now turn to the issue of…

3. Coordination with other policies

Regardless how different policy mandates are structured, ensuring financial stability is a shared responsibility. Other policies, for which financial stability is—at most—a secondary objective, should not lose sight of the systemic consequences of their action, or inaction, and should not be a source of financial instability. An especially prominent role is played by microprudential policy and monetary policy, both of which affect the amount of risk the financial system is willing (and able) to bear. For example, the larger the buffers created by microprudential policy, the smaller the need for macroprudential policy to step in.

Macroprudential and other policies interact in complex ways that are not yet fully understood. Policy conflicts may arise. For instance, if monetary policy is loosened for a long period, macroprudential policy may want to become tighter to avoid excessive risk-taking. Or, if macroprudential policy encourages drawing down bank capital buffers in a downturn to sustain the flow of credit, microprudential policy may be inclined to keep buffers unchanged to guard against the heightened risks.

All this calls for mechanisms for coordination across policies, which should be done in a manner that fully respects the independence of policies in different areas. Coordination will be particularly important where the operational control over the macroprudential instruments may not rest with the macroprudential body itself. Moreover, we need to acknowledge that the macroprudential policy should be viewed as a complement, rather than a substitute to macroeconomic and microprudential policies.

Obviously, many questions remain unanswered in this area, and hopefully today’s discussions would help clarify some of them.
Finally, **international cooperation should complement national frameworks for macroprudential policy.** We live in a globalized world, and multilateral aspects of macroprudential policies have to be taken into account. The benefits of international cooperation in macroprudential policies are multifaceted.

First, cooperation in macroprudential policies can reduce the scope for international regulatory arbitrage that may otherwise undermine the effectiveness of national policies—for example, when tightening requirements on domestic banks lead to a provision of credit by foreign parent institutions.

Second, cooperation and information sharing in macroprudential policies can help address cross-border interconnectedness and mitigate the risk of cross-border distortions and spillovers and the potentially destabilizing effects of capital flows.

*As we can see, much work is needed to develop the macroprudential framework, because many operational and analytical underpinnings are not yet fully understood.*

But macroprudential policy is only one tool to strengthen the resilience of the financial sector and improve our capacity to prevent and manage crises. At the same time, efforts are being made to develop instruments aimed at improving the resolvability of SIFIs and enhancing the cross-border cooperation framework.

Indeed, there are efforts to develop guidelines for **contingent capital** and **bail-in instruments**. And further effort are need to develop more effective **resolution tools** that can preserve financial stability in an increasingly complex and interconnected global system, while allowing losses to be borne by creditors rather than taxpayers.
Finally, while *supervisory colleges* are an important tool, they are relatively new and continue to evolve as jurisdictions become more comfortable with the process. Colleges should lead to stronger relationships and more joint-reviews by home and host-supervisors. Here again, work is being done by standard setters to upgrade the guidance in this area; and the FSB suggests that follow-up work should be done to test the effectiveness of such colleges.

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It is apparent that, despite recent progress, many issues remain unresolved, and the challenges facing policymakers are daunting. We should not be intimidated by the complexity of our task, and we should maintain the momentum for promoting courageous reforms of the financial systems. This is a journey that we have to make collectively, and today’s conference is an excellent opportunity to make further progress.

Still, as we strive to define the framework for macroprudential policy, we should not forget that this will not be a panacea for all problems in financial systems. The message that we are trying to convey at this year’s conference is that we should see *both the “forest” and the “trees”*. 

Macroprudential policy is not meant to be a substitute for sound policies in other areas—including *strong regulation of individual institutions, intrusive and vigilant prudential supervision*, and *sound macroeconomic policies*. In order to enhance the effectiveness of financial system surveillance, we need to encourage close interaction among all policies that help maintain financial stability.

The Fund stands ready to support such efforts through its surveillance mandate and financial sector expertise. Our collaboration with the FSB and BIS will enhance our understanding of macroprudential policies.
We hope that you will use this opportunity to share your insights and experiences, so we can improve our common knowledge and understanding of macroprudential policy and its interactions with other public policies.

I wish you all productive discussions today, and I look forward to our continued dialogue in the period ahead.