

MACROPRUDENTIAL POLICYMAKING IN EMERGING EUROPE AND CENTRAL ASIA

Policy Brief

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Summary

Macroprudential policy should aim to limit the risk of widespread disruptions to the financial system as a whole, using prudential instruments calibrated to target the sources of systemic risk. Macroprudential frameworks are defined by i) the institutional set-up; ii) available policy tools; and iii) analytic capacity. This Note outlines the approaches to macroprudential policymaking in Europe and Central Asia (ECA) countries¹ and finds that:

- i) In most ECA countries banking supervision/regulation is within the remit of the central bank. This provides the central bank direct access to supervisory information and direct control over traditional microprudential policy tools that can be used for macroprudential purposes. Within ECA central banks there is, however, only slow progress on the necessary de-lineation of micro- and macroprudential policy, and on the systematic integration of the new macroprudential function into central bank policymaking in general.
- ii) A variety of policy tools are already actively used for macroprudential purposes, but ECA countries in general have not yet initiated a substantial tightening of their macroprudential stances (and so potential political resistance has not yet been tested).
- iii) Macroprudential analytic capacity is gradually building up in ECA central banks, but so far focuses mainly on systemic risk monitoring rather than policy simulations.

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¹ This Note covers the experience of countries known in World Bank terminology as "Europe and Central Asia (ECA) borrowing countries", referring collectively to the new EU Member States of Bulgaria, Croatia, Poland and Romania; the Western Balkans; Turkey and countries of the former Soviet Union. The findings are based predominantly on technical assistance to central bank financial stability departments and financial crisis simulation exercises (CSEs) provided by the World Bank's Financial Sector Advisory Centre (FinSAC) in the ECA region during 2012-15.

Main determinants of macroprudential frameworks

- 1. The effectiveness of the macroprudential framework in a given country is jointly determined by the institutional set-up, the available policy tools and the analytic capacities. International standard-setting bodies agree that, in any institutional set-up, the central bank should be a key player in macroprudential policymaking. In most ECA countries the central bank has a legal mandate to pursue not just pricebut financial stability too. Thus, the legal mandate for macroprudential policymaking is not much of an issue in practice; it is at the very least an implicit, but sometimes also an explicit, central bank function. A much more important practical feature of the institutional set-up is whether banking supervision/regulation is integrated within the central bank or operates as a separate authority. This is because, apart from a few "pure" macroprudential tools such as the countercyclical capital buffer and the systemic capital surcharge stipulated by Basel III, most macroprudential policy tools are actually microprudential tools that can be calibrated and used also for macroprudential purposes (LTV, PTI and sectoral credit caps, etc.).
- 2. If the central bank houses banking supervision under the same roof it naturally has access to the full range of traditional microprudential tools and can deploy them as macroprudential instruments if and when it deems it necessary. If banking supervision/regulation is a separate entity with a separate (microprudential) mandate, the range of potential macroprudential tools directly available for the central bank is much more limited. In such set-ups the central bank can, however, have an indirect influence on these tools if a multi-agency agreement to coordinate macroprudential policy is in place (for example as part of the mandate of a national Financial Stability Committee or a dedicated Macroprudential Board).
- 3. Macroprudential analysis in central banks has two distinct areas or "stages of development": systemic risk monitoring and the more complex task of macroprudential policy simulation. The balance between these two areas of analysis (as well as the overall resources dedicated to them) will depend on how much leverage the central bank has on macroprudential policymaking, either through direct control of policy tools or indirect influence via a multi-agency coordination agreement. If the central bank's direct tools are limited, and its role is more or less restricted to being

a "whistleblower", its analysis is not likely to go beyond monitoring systemic risk and won't include a comprehensive analysis of the impact of alternative policy options (policy simulation).

Pure macroprudential tools only, or access to microprudential as well?

Policy
Tools

Banking supervision within central bank or separate?

Staff numbers, balance btw risk monitoring/policy simulation

Analytic Capacity

Figure 1: Key elements of a macroprudential framework

Observations regarding the macroprudential frameworks in ECA

Institutional set-up

4. In the majority of ECA countries the central bank includes banking supervision/regulation, which greatly determines the macroprudential institutional setup. Since ECA-country financial systems are predominantly bank-based, banking supervision is the most important supervisory/regulatory function. The overwhelming majority (20 out of 23) of ECA countries have banking supervision integrated within their central banks. This figure was also shaped by decisions of some of these countries following the global financial crisis to quit the model of separate banking supervision and bring this responsibility (back) to the central bank (Georgia in 2009, Kazakhstan more recently). These changes were in line with the wave of integrating bank supervisors in central banks that was taking place globally following the global

financial crisis. Of the three ECA borrowing countries where banking supervision is not within the central bank two (Poland and Turkey) are large economies and one has a complex federal system (Bosnia-Herzegovina). At the end of 2015, after lengthy discussions, Poland set up a multi-agency Financial Stability Committee with the participation of the central bank, the responsibilities of which include macroprudential supervision. The general conclusion is that, in most ECA countries, the central bank has an undisputable key position in macroprudential policymaking with direct access to supervisory information and to the full range of microprudential tools.

5. The de-lineation of micro- and macroprudential policy within ECA central banks is in progress, but not without conflicts. There is now a more explicit focus on systemic risk in ECA countries, in line with worldwide trends following the global financial crisis. The macroprudential perspective has received more attention and almost all ECA central banks have set up financial stability units (most recently in Ukraine) and started to publish financial stability reports. In some cases, newly established financial stability units have faced suspicion, conflicts and fighting for prestige with the incumbent banking supervision organizational units. Coordination and data sharing between them remains problematic in some countries. Financial stability units often find it difficult to flourish in the shadow of strong and well-established supervision departments. Financial stability staff have a somewhat different "cultural background" as they tend to come from the economics/research areas of the central bank and sometimes struggle to "speak the same language" as their supervisor colleagues. Examples for successful development of financial stability units include Macedonia, where former supervisors work alongside colleagues with an economics/ research background, and Armenia, which places Supervision and Financial Stability under the same deputy governor to minimize the risk of prestige clashes. Although being under the same deputy governor might give rise to conflicts of interest over the long term, it is perhaps helpful in "nurturing" new financial stability units in the critical period after their establishment.

6. The systematic integration of the macroprudential area into central bank policymaking is taking place at a slow speed and with varying degrees of success. Some advanced countries recognize the advantages of a clear division of macroprudential, microprudential and monetary policy decision-making within the central bank (example: the Bank of England's Monetary Policy Committee vs its Financial Stability Committee). In ECA countries, the central bank's supreme decision making body (CB Board) typically retains universal responsibility for policymaking in all three areas. In some instances, internal advisory bodies have been set up to channel policy advice from the staff to the CB Board. These Committees, typically consisting of stakeholder department heads and chaired by a relevant member of the CB Board, meet regularly and are the primary fora for efforts to formulate a consensus staff view. Internal Financial Stability Committees set up this way tend not to operate as a purely macroprudential forum, but to deal with microprudential and crisis management

issues as well. There are also a few examples in ECA central banks where separate internal committees exist for micro- and macroprudential discussions (Supervision Committees vs. Financial Stability or Macroprudential Committees).

7. The tasks of national Financial Stability Councils (FSCs) are envisaged to include facilitating macroprudential coordination, but their typically mixed identity of crisis management and crisis prevention often leads to ineffectiveness. In many ECA countries a national-level FSC consisting of the central bank, the ministry of finance (MoF) and sometimes various other stakeholders (deposit insurance, securities market regulator, parliamentary committee on finance, etc.) was set up post-global financial crisis. FSC mandates often mix crisis management functions (such as bank resolution) with crisis prevention functions (micro- and macroprudential policies). In crisis management, with the high potential requirement for public funds, it is natural that the government (MoF) gets involved and plays a crucial role. In contrast, however, crisis prevention can require the imposition of politically unpopular prudential measures and should be led by the independent supervisor/regulator (in ECA most often housed in the central bank) without political interference. The mixed identity of FSCs can also mean that in "normal times", when crisis prevention (micro- and macroprudential policymaking) is in focus, the MoF does not find a relevant role for itself in the committee. Consequently, regular national FSC meetings often become delegated to staff level, become less frequent or cease to be held altogether. When the crisis hits and its costs and consequences become clear for the general public, those members of the FSC that do not have a direct influence on prudential policies often find themselves to be unfairly blamed for what the public perceives as past supervisory mistakes.

Policy tools

8. ECA central banks have been actively using a variety of policy instruments for macroprudential purposes, but a significant tightening of the macroprudential stance has not happened yet. Most central banks in ECA have already had some experience with using macroprudential policy tools. Even the institutionally most constrained ECA central bank (Central Bank of Bosnia-Herzegovina: currency board, separate banking supervision) reports having used its only available policy tool (changes in minimum reserve requirements) for macroprudential purposes in the past. In the aftermath of the global financial crisis and with sluggish or negative credit growth, the macroprudential stance in ECA countries was typically tilted towards easing. In recent years some market segments (e.g. consumer loans) started to show signs of excess in some countries, which triggered some macroprudential tightening (typically PTI caps). In general, though, ECA has not undergone sizeable macroprudential tightening since the crisis. Consequently, macroprudential authorities have not yet

experienced the likely political resistance that such tightening may entail and may not be prepared to tackle it (e.g. with strong public arguments substantiated with robust analysis).

9. The use of "pure" macroprudential tools such as the countercyclical capital buffer (CCyB) or the systemic capital surcharge, is currently limited in ECA. ECA countries that are EU Member States (Poland, Bulgaria, Romania, Croatia) must introduce these tools under the EU's capital requirements regulation and Directive (CRR/ CRD IV). CCyB is being phased in from 2016. EU-candidate and potential candidate countries will have to endorse CRR/CRD IV on their legislative progression to EU standards. ECA countries that are not EU-members or candidates but who have endorsed Basel III will introduce the tools in the near future (e.g. Turkey and Russia as members of the Basel Committee). For the remaining ECA countries there are no known timetables or clearly identifiable motivating mechanisms for implementation. That said, ECA countries with a significant presence of Western European banks in their financial systems should consider the domestic implementation of macroprudential tools such as the CCyB, otherwise the parent supervisor will set the buffer for the subsidiary at its discretion. The identification of domestic systemically important banks (D-SIBs) is already a widespread practice in ECA. However, systemic capital surcharges are typically not levied on the D-SIBs identified, at least not for the time being. Besides its use in macroprudential policymaking, the identification of D-SIBs is also important for crisis preparedness, as the resolution of systemically important banks can be very different from that of small ones. In some countries authorities involved in bank resolution are legally constrained to use public funds only in the case of D-SIBs, therefore the ex ante identification of these banks is crucial.

Analytic capacity

10. Macroprudential analytic capacity is gradually building up in ECA central banks. The content of Financial Stability Reports of ECA central banks reveal their improving capacity to perform systemic risk monitoring, both in the time-series and the cross-sectional dimension. Stress-testing, especially for credit risk, is now a wide-spread macroprudential analytic tool in ECA central banks but to a varying extent, from simple scenario analysis to estimated credit risk models with feedback loops. Regular stress testing of liquidity is less universal in ECA countries. It typically follows the principles of the Basel III Liquidity Coverage Ratio. Identification of D-SIBs is in place almost everywhere, but more for crisis preparedness purposes than for levying a capital surcharge. There has been less progress with analytic tools aimed at: (i) measuring the current degree of stress (Financial Stress Indices); (ii) forecasting future stress (Early Warning Systems) and (iii) measuring the policy stance and its impact on intermediation (Financial Conditions Indices). Nevertheless, regular lending surveys

to capture lending conditions are in place in a number of countries (such as Albania, Armenia, Kazakhstan, Kosovo, Macedonia, Romania, Serbia and Ukraine).

11. Currently, macroprudential analysis in ECA rarely goes beyond systemic risk monitoring: more active future macroprudential policymaking will require impact assessments of policy measures, that is, the capacity to do macroprudential policy simulations. The focus of macroprudential analysis in ECA is so far predominantly on systemic risk monitoring. A more activist macroprudential policymaking, especially in the tightening phase when it meets political resistance and needs to be publicly defended, requires strong arguments substantiated with robust impact assessment of various policy alternatives. In other words, the analysis has to go beyond monitoring systemic risk and has to incorporate macroprudential policy simulation (Figure 2). This ideally requires a macro model with a representation of the financial system, which is work in progress even in advanced country central banks. Until such models become available, analysis has to rely on certain shortcuts, such as rules-of-thumbs for bank behavior in reaction to macroprudential tightening/loosening (expressed in credit supply) and some quantifiable views on the impact of credit supply shocks on the real economy. Very few central banks in ECA have yet started to address these analytic challenges.

Figure 2: Macroprudential Analysis = Systemic Risk Monitoring + Policy Simulation

Key questions macroprudential decision-makers have to face:

