MONETARY AND
CAPITAL MARKETS

Institutional Arrangements for Effective Macroprudential Policy

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Overview

Three challenges to the effective pursuit of macroprudential policy (Nier 2011).

- deeply rooted in the objectives of macroprudential policy

Challenges map to desirable elements for macroprudential institutional frameworks (IMF 2013, 2014, IMF-FSB-BIS 2016):

- Willingness to act,
- Ability to act,
- Mechanisms to ensure cooperation and coordination

Some detail on various dimensions

IMF FSAP advice on institutional arrangements since 2014

Three Challenges (1)

First challenge: Macroprudential policy is subject to biases that favor inaction or insufficiently forceful and timely action (**Inaction Bias**) (Nier 2011)

Flows from the nature of the policy problem: macroprudential policy manages a tail risk

- The benefits of action accrue in the future and are difficult to measure
- The costs of actions are more visible and felt immediately, by financial firms and borrowers

Biases are compounded when macroprudential policy is subject to:

- Lobbying by the financial industry
- Political pressures

➢ Requires mechanisms to ensure **willingness to act**

Three Challenges (2)

Second challenge: the financial system evolves dynamically:

- The level and distribution of risks are subject to change

The financial system will evolve to seek profitable opportunities. Can evolve in response to:

- Financial innovations (technological innovations)
- Regulatory constraints (leakage problem)
- Distortions caused by other policies (e.g., Fiscal distortions that favor debt)

➢ Requires mechanisms to ensure **ability to act**, including assessment capacity and powers to seek information and control risks.

Three Challenges (3)

Third challenge: macroprudential policy mitigates risks across the financial system as a whole (IMF 2011).

This requires cooperation and coordination across potentially separate sectoral regulators.

- Can be challenging amongst institutions that each have their own mandates and responsibilities.
- Can be hampered even within organizations, due to "turf" and intra-organizational competition.
- Need for coordination can reinforce inaction bias.

➢ Requires **mechanisms to foster cooperation and coordination** across the (potentially separate) agencies whose contribution is needed to assess and mitigate risks.

Desirable Elements of Frameworks

Macroprudential policy manages tail risk	⇒	**Willingness to act**
Financial system evolves dynamically	⇒	**Ability to act**
Need to control risks across the entire system	⇒	**Mechanisms to elicit coordination and cooperation**

Willingness To Act

Clear assignment of the mandate to someone (a body or committee)

Strong role for the central bank (CB)

Decision-making that avoids veto on the part of other stakeholders

Objectives and accountability mechanisms

Institutional Foundations
Three Models

Model 1. Integrated in the Central Bank	• Czech Republic, Ireland, New Zealand, Serbia, Singapore
Model 2. Dedicated committee within the central bank	• UK, Hungary, Iceland, Malaysia, Thailand
Model 3. Committee outside the central bank	• United States, France, Germany, Poland, Romania, Turkey

Strong Role of The Central Bank

The central bank should play an **important role** regardless of type of model

- **Expertise** in systemic risk identification
- **Incentives** to pursue macroprudential policy effectively (Nier, 2009)
- **Independence** - less prone to be affected by political pressure
  - Policy response time appears to be shorter with greater central bank involvement (Lim and others, IMF Working Paper, 2013)
  - Edge and Liang (2019): central banks more effective as part of a committee. Need for political backing

In a committee setting a strong role can be achieved by CB chairing (e.g., Poland, Romania) or CB providing its analysis and recommendations to the committee (e.g., France and Germany)

Other Stakeholders and Voting Arrangements

Participation of the Ministry of Finance on macroprudential committees can be useful

- to ensure some degree of political backing for measures taken
- to help elicit broader political support for legislative initiatives.
- to help discussion of fiscal measures to reduce systemic risk (debt biases)

The **MoF should not play a dominant role**, e.g., not have a veto over policy decisions.

Voting arrangements should enshrine **majority voting**, rather than requiring unanimity or consensus.

- Unanimity effectively assigns a veto to all members, potentially paralyzing decision-making.

Objectives and Accountability

Accountability should be based on a clear objective and strong communication

A **clear objective** for macroprudential policy anchored in law creates incentives to act and fosters legitimacy of macroprudential action.

Financial stability should be the **primary objective** of the macroprudential function, ensuring this objective is prioritized institutionally (e.g., Moldova FSAP).

Strong **communication** helps create public awareness of risks and understanding of the need to take necessary action. This can include

- Publication of a **policy strategy** (e.g., BoE, Swiss National Bank, Norges Bank)
- **Periodic reports** (e.g., FSR) that reviews risks and policy action taken
- **Records** (press releases) setting out deliberations and decisions

Ability To Act

Effective macroprudential policy requires powers (IMF, 2013).

When the financial sector evolves dynamically, powers are needed to:

- Obtain information; wield policy tools; expand the range of action
  - Beyond established tools or the existing regulatory perimeter

Useful to combine powers of different strength:

- Hard, semi-hard and soft

Policymaker also requires capacity to assess risks and formulate policy proposals

Powers Assuring "Ability To Act"

Hard Power	• To issue regulations or make binding decisions. ➢ Confers control over the calibration of specific types of tools.
Semi-hard Power	• To issue a formal recommendations to other regulatory agencies, coupled with a **'comply or explain'** mechanism. ➢ Broadens scope of action ➢ 'C or E' improves compliance and public accountability.
Soft Power	• To issue an opinion or recommendation that is **not subject to comply or explain**. ➢ Useful to initiate legislative change, or to influence other policy settings. But unlikely to be sufficient.

Financial Stability Unit

A dedicated financial stability unit can be charged with analysis of risks and development of policy proposals

- Can bring **analysis** and **recommendations** for consideration by decision-makers
- Can support **meetings** of policymakers at a regular frequency (perhaps quarterly)
- Can keep the **“policy wheel”** turning
  - Including initiation of investment in data collection, etc.

Such units should be given staff **resources** and set up as a **department** within the central bank, reporting to the Governor or Deputy Governor (e.g., Philippines FSAP).

Mechanisms To Ensure Cooperation and Coordination

Across all agencies whose contribution is needed to ensure effective risk assessment and risk mitigation.

- Banking supervisor
- Securities and Insurance regulators

Consolidating regulatory structures can be conducive (e.g., Iceland, CB Ireland)

- Internal mechanism for coordination may still be needed.

Coordination councils can help initiate discussion and solicit inputs.

Provision of data to the macroprudential authority needs to be enabled by law.

Financial stability should be among the legal **objectives** of separate sectoral agencies.

- Allowing their hard powers to be used for financial stability.
  - As for the FCA in the UK, and recommended in several FSAPs (e.g., US).

FSAP Advice on Macroprudential Policy

The **Financial Sector Assessment Program** (FSAP) is an important conduit for IMF advice on financial risks and oversight.

Since publication of IMF guidance, FSAPs have covered macroprudential policy frameworks more systematically.

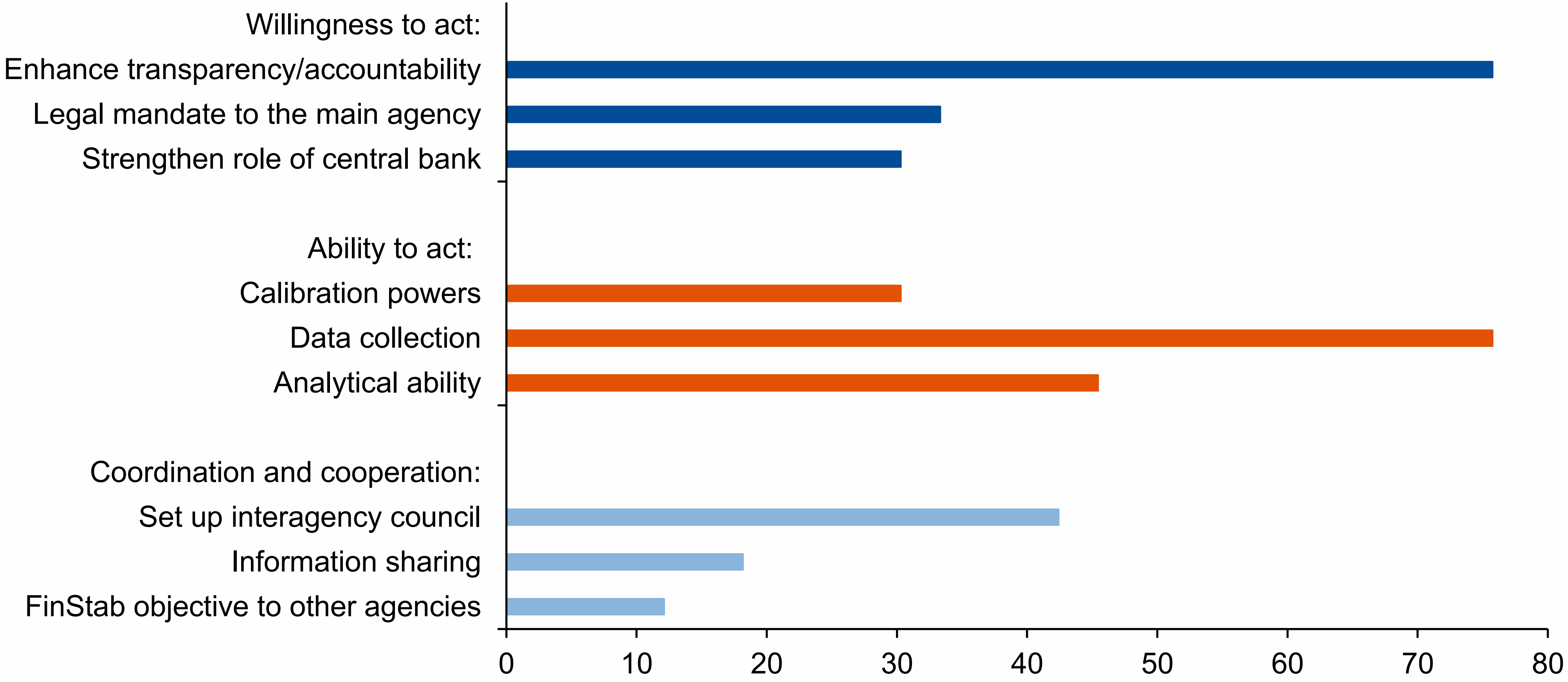
IMF FSAP Technical Notes (TNs) cover:

- Institutional arrangements
- Operational readiness (data, analysis and toolkit)
- Macroprudential policy settings – in light of the FSAP’s risk analysis

Institutional advice proposes mechanisms to strengthen the framework based on a diagnosis of weaknesses across three dimensions covered above.

FSAP recommendations

Share of FSAPs with a recommendation in the area
(of 33 FSAPs since 2015, %)



Source: IMF staff calculations

Conclusions

Strong institutional arrangements are essential for macroprudential policy to be effective. These arrangements should assure (IMF, 2013):

- Willingness to act;
- Ability to act;
- Mechanisms to ensure cooperation and coordination in risk assessment and mitigation

Progress is being made. More progress is possible.

References

Nier, Erlend, 2011, "Macroprudential Policy - taxonomy and challenges"

Nier, Erlend and others, 2011, "Institutional Models for Macroprudential Policy" IMF SDN 11/18

IMF, 2011, "Macroprudential Policy: An Organizing Framework"

IMF, 2013a, "Key Aspects of Macroprudential Policy"

IMF, 2013b, "Interaction of Monetary and Macroprudential Policy"

IMF, 2014, "Staff Guidance Note on Macroprudential Policy"

Viñals and Nier, 2014, "Collective Action Problems and the Need for International coordination"

Extra Slides

Coordination: Microprudential Supervision

Effective microprudential supervision is essential to ensure that the macroprudential policy stance is enforced (IMF, 2013a)

Supervisory **data** are indispensable for risk assessment

- May need expanded supervisory data (e.g., on exposures)
- Sharing of data – can sometimes require changes to the law

Differences in perspectives can be useful but may also need to resolved

- **Participation** of separate supervisory agencies / the head of supervision in decision-making
  - Creating ownership
- Supervisory agencies should be given **objective** to contribute to financial stability (e.g., UK, recommended in US FSAP)
  - Fostering engagement

Coordination: Monetary Policy

Monetary policy and macroprudential policy are separate policy fields with different objectives, even if they also interact (IMF, 2013b)

Useful to establish:

- **Distinct primary objectives for each policy function**:
  - Monetary policy: price (and output) stability
  - Macroprudential policy: financial stability
- **Dedicated decision-making structures for each policy function** (e.g., separate committees, or focused Board meetings)
- **Separate communication and accountability mechanisms**

Coordination in a manner that preserves independent pursuit of monetary policy:

- Overlapping membership (CB) and common analysis provided to both decision-makers

Coordination: Crisis Management

Macroprudential policy can contribute to management of crises,

- E.g., by relaxing macroprudential buffers

Crisis management can require policy action far beyond macroprudential policy (e.g., monetary, fiscal, resolution)

Dedicated arrangements for crisis management can allow

- The MoF to play a strong role, when the central bank is at the center of macroprudential policy
- Participation of deposit insurance and resolution agencies

Overlapping membership can foster coordination, assuring “Ability To Act”

Cross-border Coordination

Time dimension: Policies to contain excessive domestic credit can lead to an increase in credit provided across borders (“leakage”)

- Ensure **“reciprocity”** in the application of macroprudential tools
  - Enshrined in Basel III for the countercyclical capital buffer (CCyB)
  - Especially important for **financially integrated** regions
  - Bilateral and regional arrangements can ensure that reciprocity applies in practice and **across the range of tools targeting exposures** (e.g., in EU)

Structural dimension: Policies to strengthen the resilience of systemic institutions in one country can cause their activities to migrate to other countries

- This can lead to a **race to the bottom** and greater concentration of risky activities in less strictly regulated jurisdictions (IMF 2013, Vinals and Nier 2014)
  - Can be addressed by international (or regional) agreements and guidance
  - BCBS guidance for national authorities to assess capital surcharges for domestic systemically important banks (D-SIBs)
  - FSB-led reform of regulation for open-ended investment funds (FSB 2023).