"MACROPRUDENTIAL POLICIES TO ACHIEVE FINANCIAL STABILITY" - CONFERENCE HOSTED BY THE CENTRAL BANK OF URUGUAY AND THE IMF

COMMENTS MADE ON THE PANEL: "EFFECTIVENESS OF POLICIES TO ADDRESS THE SYSTEMIC FINANCIAL RISK"

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1. Recent studies by the World Bank and the IMF[1] suggest there is a consensus to enhance the current financial stability framework. Aspects such as (i) the degree of institutional integration between the Central Bank and financial regulation; (ii) the legal mandate to design macro prudential policy; (iii) the role of the Ministry of Finance in designing the regulatory framework and (iv) the existing coordination instruments, are decisive to design which is the best for each jurisdiction. What is clear is that there is no single model that fits all countries.

In the "session notes" prepared by the IMF and the Central Bank of Uruguay, it is noted that macro prudential instruments have been used extensively to reduce systemic risk. The decision to use these tools depends critically on constitutional and legal mandates. In particular, the decision should take into account if there is a preference for: (i) single versus multiple instruments; (ii) broad based versus targeted measures; (iii) fixed versus time varying; (iv) rules versus discretion and (iv) coordination with other policies (monetary and fiscal). Each of these options implies different pros and cons and its use will depend on the objective it wishes to achieve.

We have been asked to make comments on the effectiveness of macro and micro prudential policies, in particular, a potential reduction of the scope of circumvention through the use of multiple instruments, since they address aspects related to the same risk. These notes will focus especially on the importance of an adequate institutional framework and coordination needed between macro and micro prudential measures.

[1] "Institutional Models for Macroprudential Policy" , IMF Staff Discussion Note SDN/11/18.

2. During 2007-2008, Colombia experienced a situation wherein the economic growth rate exceeded 7% with clear signs of overheating. The financial sector showed high growth rates of credit (32% in real terms), and indicators of loan payments deteriorated rapidly. Under those circumstances, different instruments were used to reduce credit growth as well as negative risks of a downturn in the economic cycle.

Some of the instruments implemented included:

- An increase in the policy interest rate of the Central Bank.
- The adoption of marginal reserve requirements to all credit institutions.
- The adoption strengthening of dynamic provisioning required to credit institutions.
- Limits on the exposure of financial institutions in operations with derivatives.
- Voluntary restrictions on profit distribution of all financial institutions, as a mechanism to increase future capital needs.

Additionally, the Central Bank imposed controls over the foreign debt exposure of residents in as a suplementary measure to limit credit growth. Furthermore, restrictions on portfolio investments from abroad were adopted, with the purpose of reducing short term capital inflows.

This set of instruments were adopted by the Central Bank, the Financial Supervisor and the Ministry of Finance (Financial Regulator), in compliance with the Colombian legal framework and supplemented existing restrictions imposed to the maturity mismatch of foreign currency assets and liabilities and limits on the cash foreign assets positions of banks. [2]

After the events that led to the fall of Lehman Brothers, the Colombian economy experienced a slow down due to the global financial crisis. The authority's response was to abolish some of the measures adopted. Fiscal stimulus was used to reduce the negative impact caused by the abrupt changes in the cycle, and monetary policy was eased as well.

3. **There is no doubt institutional settings matter**. In Colombia we have a full separation between the Central Bank, the Financial Superintendence and the Ministry of Finance. Each of the above mentioned agencies focus on their own objectives. Nevertheless, they have a legal mandate to work in a coordinated manner. The aforementioned set of instruments was successfully adopted thanks to:

[2] Credit operations in foreign currency must be funded by a liability in the same currency and with a maturity longer or equal to that of the asset.

- An independent central bank with a highly technical staff and a clear mandate focus on price stability and oversight of the payments system.
- A flexible exchange rate regime adopted since the late 1990s
- A legal framework that allows flexibility in the adoption of different instruments. In the case of the Central Bank, some of micro prudential nature (i.e. the possibility of imposing limits to the exposure of local agents with foreign counterparties).
- An integrated financial supervisor in charge, not only of banks but also securities and pension markets, and pension funds. A risk based supervisory approach allows the supervisor to act in a proactive and even intrusive manner over individual financial institutions.
- A deposit insurance, with proven experience in resolution of failed institutions.

4. **Coordination is a key element for the success of an institutional model with full separation.** As was mentioned by the IMF: "effective coordination across policies and among agencies is crucial to reduce gaps and overlaps". Following are some of the aspects that facilitate this coordination:

- The participation of the Ministry of Finance as a board member of the Central Bank, but lacking veto power. The experience of the independent central bank shows that the participation of the Ministry allows coordination between the goals of the central bank and those of the government, without compromising its independence. The participation of the Ministry is recognized by the Constitutional Court as an instrument of coordination.
- The participation of the Governor of the Central Bank and the financial supervisor in the board of the deposit insurance agency (FOGAFIN)
- The participation of the Ministry of Finance, the Governor of the Central Bank, the Financial Superintendent and the director of FOGAFIN in the Financial Stability Council. This council was created as an informal forum during the financial crisis of the late 90s, and was later formalized by law as a coordination instrument.

With regards to the Financial Stability Council, it must be noted that a long and medium term agenda was established and that it includes structural topics with a clear mandate for the cooperation and sharing of information.

Recently it is common practice for the SFC to submit presentations to the board of directors of the central bank, relating credit and liquidity issues as an additional input for monetary policy decisions.

5. As result of the coordinated work the following policies are worth mentioning:

- Changes in the calculation of the provisions applied to retail loans, as well as the assessment of valuation methodology of warranties. As a result of this, provisions increased 8.4% during 2011 and further increases are expected for 2012, once the new methodology fully applies.
- New regulation on liquidity risk management introducing a new band of 30 days and obligatory requirements to maintain liquid assets accepted by the Central Bank as collateral, following Basel III recommendations.
- New regulation related with quality of capital of banks is expected in this year.
- The Central Bank has worked extensively on interconnection analysis of the financial system and, recently, on establishing criteria to determine systemic financial institutions.
- The insurance deposit agency introduced new regulation to reduce the time needed to reimburse deposits in case of a bank failure.

6. **The use of multiple instruments prevents reliability upon a single instrument**. Our experience is that the coordinate use of different tools can complement the strength of single instruments. What we have learned is that a restrictive monetary policy can be complemented with an increase in reserve requirements and strengthening of loans provisions. Each of these instruments target different risks, and vary in terms of timing and implementation costs, as is the case of reserve requirements and loan provisions.

My experience as the legal secretary of the Board of Directors of the Central Bank taught me the following:

- Instruments are more effective when they are simple, and can be adequately monitored and supervised.
- Complex instruments, usually need supplementary regulation which affects effectiveness and adequate timing.
- Dealing with operational issues is critical to assure that the goals are met.

7. **Discretion is always better than rule based arrangements**. Discretion allows the authorities to evaluate and decide on the instruments used, taking into account dynamic situations and feedback effects. This provides more flexibility and allows the use of multiple instruments instead of single ones. Nevertheless when the institutional framework is weak, it's a good idea to have rules; or when a situation is not easily identified, as in the case of gray areas in distinguishing between liquidity and solvency problems. A clear definition of what was understood as insolvency, for the purpose of the last resort lending, was crucial in the financial crisis in the late 1990s.

8. **International coordination is relevant**, **especially when cross border interconnectedness is important**. During the last two years Colombian banks increased their exposure in the region,by purchasing banking operations and integrating financial markets. The response of the Colombian Supervisor to this situation has been to increase cooperation with Central American Supervisors. For such end, MoUs have been signed; the SFC has been invited to the Central American Supervisors Committee and at the beginning of the year Colombia hosted a Supervisory College for Banco de Bogotá with the participation of Supervisors of Central America and the Caribbean. This and other initiatives could be further supported by the IMF due to the increasing importance of regional banks in some countries (regional SIFIS).

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