

# Prudential Regulation: Balancing Growth and Stability

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# Outline of presentation

1. What is Prudential Regulation?
2. Micro- versus Macro-Prudential Regulation
3. The Regulation versus Liberalization Debate
4. Policy Alternatives
5. Basel III, Micro-prudential Regulation and Asia
6. An Asian Monetary Fund for Macro-prudential Management ?

# Prudential Regulation

- Designed to protect banking system from failure.
- Traditionally, transactions monitoring (e.g. adequate collateral for loans), regulations concerning self-dealing, capital requirements, and entry restrictions.
- Sometimes, sectoral restrictions on lending, e.g. real estate lending, common in East Asian.
- Many countries imposed interest rate restrictions and Capital Controls.
- To counter bank runs, the provision of deposit insurance and central banks as lenders of last resort.

# Prudential Regulation

- Since 1990, systems have changed:
- **First**, greater emphasis on monitoring banks' risk management systems, less on monitoring individual transactions.
- **Secondly**, due to financial market liberalization, interest rates deregulated, restrictions on bank entry, asset choices and capital controls lifted.
- **Thirdly**, greater emphasis placed on capital requirements, using BIS Basle Accord standards

# Micro versus Macroprudential Regulation

- Microprudential regulation focuses on the stability of the component parts of a financial system.
- Concerned with sound banking practice and the protection of depositors at the level of the individual bank.

# Micro versus Macroprudential Regulation

- Macroprudential policy refers to the use of prudential tools with the explicit objective of promoting the stability of the financial system as a whole.
- *macro-prudential approach considers problems that bear upon the market as a whole as distinct from an individual bank, and which may not be obvious at the micro-prudential level.*

# Macroprudential Regulation

Specific focus of concerns changed over time.

1. excessive lending to developing countries (1980s)
2. the impact of financial innovation and the development of capital markets (mid-1980s to late 1990s),
3. the influence of regulation on the procyclicality of the financial system (2000+), and
4. the implications of the failure of systemically significant institutions (“too big to fail”, 2007+).

Macroprudential policy has become more important due to various forms of financial liberalization, which have been very contentious

# The Liberalization – Regulation Debate

## 1. The Neo-Liberal View

- State Financial System Regulation = Financial repression and is counterproductive
- Financial Liberalization Essential for Growth and Stability
- Ultimate goal should be total financial liberalization
- Most developing countries have been successfully doing this since 1970s



# The Liberalization – Regulation Debate

## 2. The Counter Argument

- Domestic Financial Liberalization frequently failed, rarely successful (role of IMF)
- Usually leads to speculative development, currency and banking crises, income and political inequalities and financial fragility
- Markets not good for socially necessary investment or for curing waste, inefficiency or corruption
- Financial Liberalization not part of experience of development ‘successes’

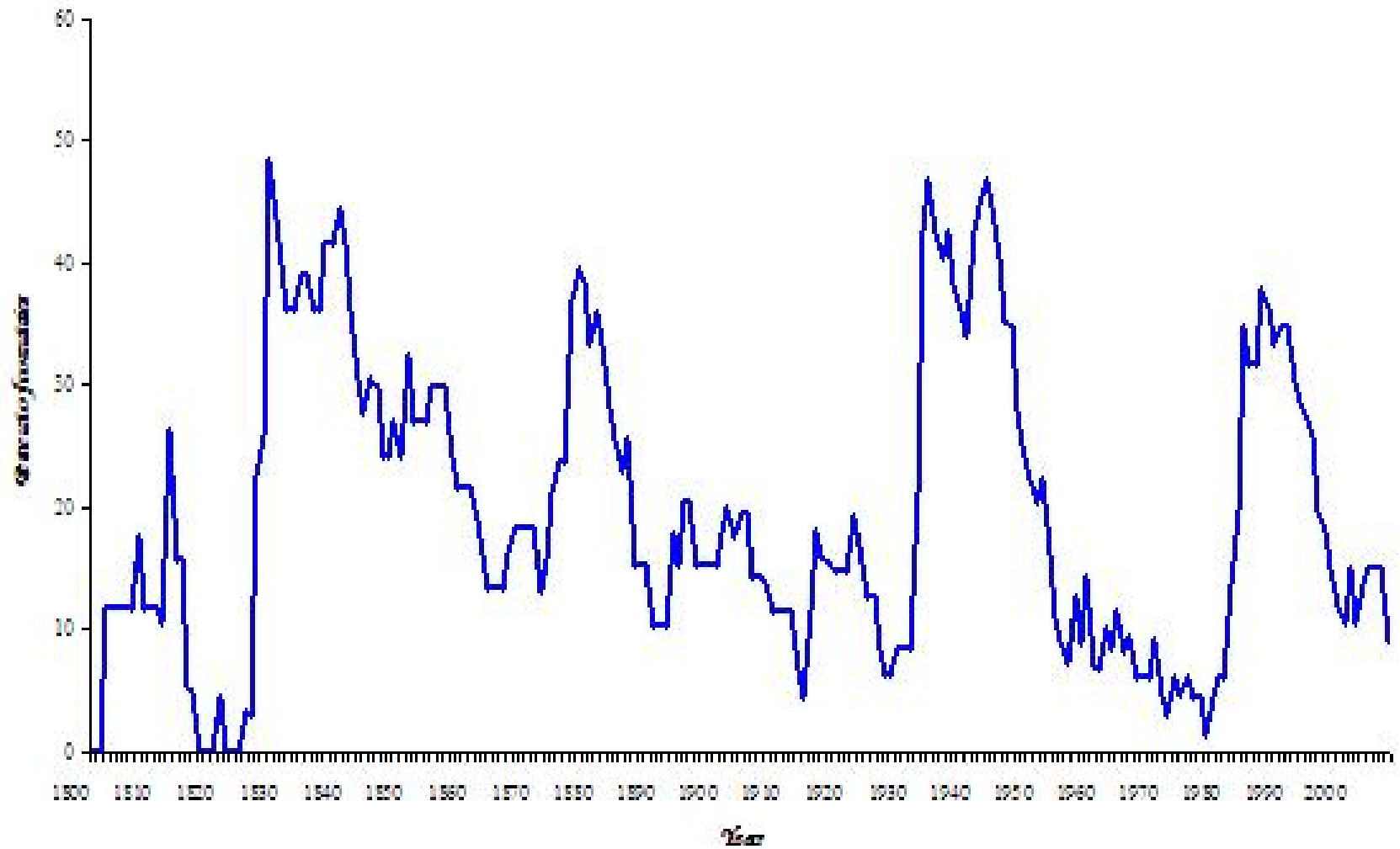
# The Liberalization – Regulation Debate

## 2. The Counter Argument

“Financial liberalization has and will continue to undermine the integrity of national financial systems, including those that have been successfully deployed for industrial and trade financing to accelerate late (export-oriented) industrialization in East Asia”.

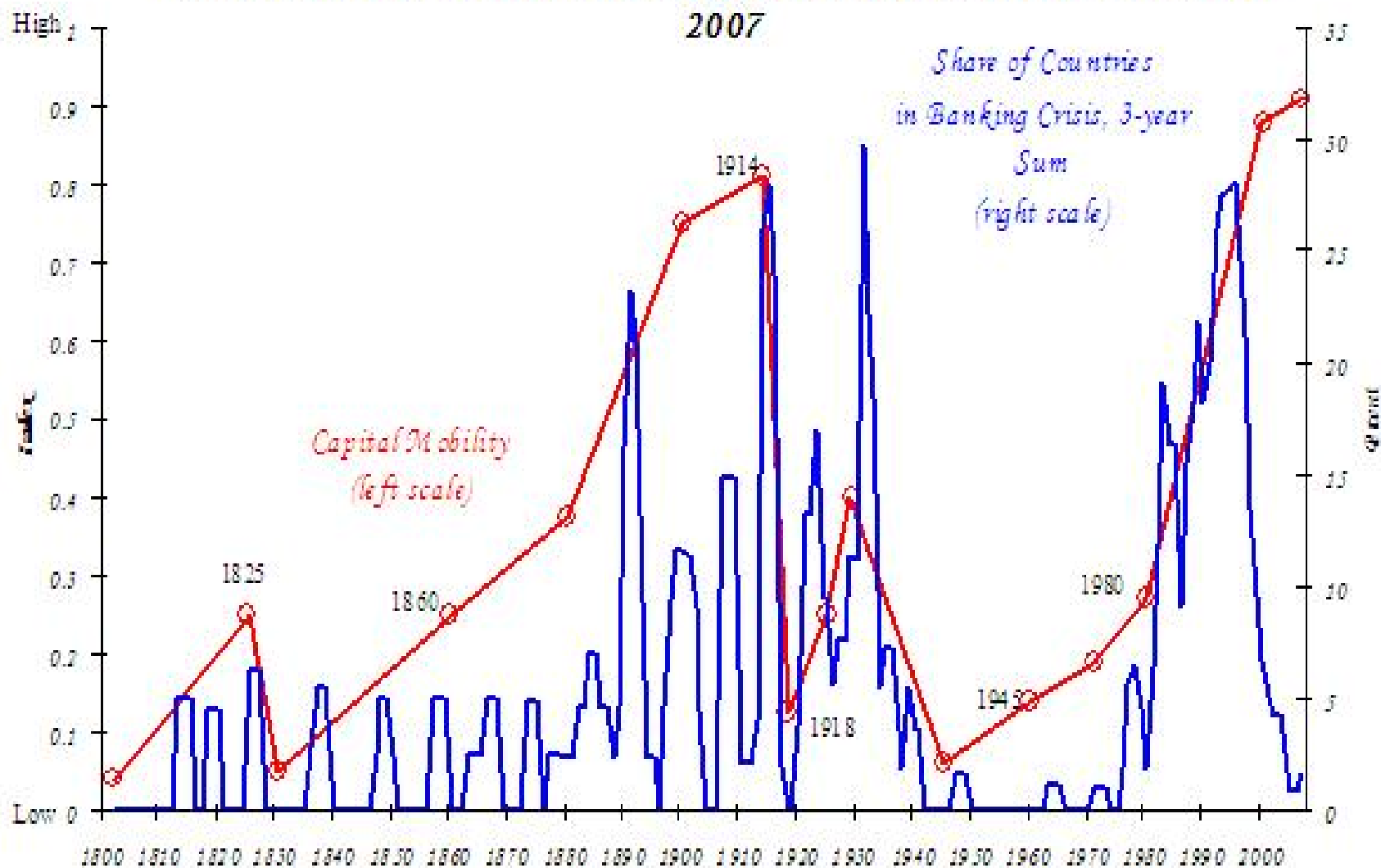
- K.S. Jomo, 2003
- ‘Financial restraint’ calls for the government to create rent opportunities in the private sector.
- Unlike financial repression, this serves both stability and development needs.

*Sovereign External Debt: 1800-2006*  
*Percent of Countries in Default or Restructuring*



Source: Reinhart and Rogoff (2008a).

# Capital Mobility and the Incidence of Banking Crisis: All Countries, 1800-



Sources: Reinhart and Rogoff (2008a), Obstfeld and Taylor (2004).

**Table 1. Banking Crises in East and South Asia (1980–2002)**

Country/Economy	Time-frame	Non-performing Loans (% of total loans)	Fiscal Cost of Crisis (% of annual GDP)	Forgone Output (% of annual GDP)
Bangladesh	1985–1996	20		
China	1990–	50	47	
Indonesia	1997–2002	70	55	39
Japan	1991–	35	24	48
Korea	1997–2002	35	28	17
Malaysia	1997–2001	30	16	33
Nepal	1988	29		2.2
Philippines	1983–1987	19	3	26
Philippines	1998–	20	13	10
Sri Lanka	1989–1993	35	5	1
Taiwan	1997–1998	26	12	
Thailand	1983–1987		1	0
Thailand	1997–2002	33	35	40
Vietnam	1997–	18		23
Average for Asia (14 episodes)	1980–2002	32	22	22
Average for rest of world (97 episodes)	1980–2002	41	15	12

**Table 2. Banking Crises and Liberalization Dates in East Asia**

Country	Banking Crisis	Decontrol of Interest Rates	Abolishing Direct Credit	Increasing Competition	Allowing Capital Flows	Privatization	Deregulation
Indonesia	1997–2002	1983	1983	1988		1996	1992
Korea	1997–2002	1991	1982	1981	1996	1983	1988
Malaysia	1997–2001	1991	1976	1985			1989
Philippines	1998–	1983	1983	1993	1995	1995	
Thailand	1997–2002	1992	1980	1992	1992	1993	1993

Source: Abiad, A. and A. Mody. 2005. "Financial Reform: What Shakes it? What Shapes it?" *American Economic Review* 95(1): 66–88.

Blank spaces denote sectors either liberalized before 1980 or not yet liberalized.

# Policy Alternatives

- Goal of financial regulation should be sustainable, stable, equitable development
- To provide finance needed and at right price to support this type of development
- Especially long-term finance for infrastructure, ISI etc. Tobin's 'functional efficiency' versus micro, risk, efficiency

# Policy Alternatives

- This might mean:
  1. Allocation and pricing of credit to key sectors
  2. Specialized lending institutions, for women, micro- or small scale credit, green co's etc
  3. Asset based reserve requirements, by asset, sector, variable, held at central bank
  4. Creation of Development Banks, public, joint domestic or foreign capital



# Development Banks

Especially important:

1. Infrastructural sector is characterised most often by lumpy investments, long gestation lags, higher risk and lower monetary returns.
2. Offers “economy-wide externalities”, social returns higher than private
3. Capital shortage unless state intervenes
4. State must ensure adequate credit at favourable interest rates, for investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. Chakravarty

# Development Banks

- Financial sector must be designed to include institutions, sources of finance and instruments that can bridge the significant mismatches in expectations with regard to maturity, liquidity, risk and interest rates between savers and investors.
- One way to deal with this problem is to encourage the growth of equity markets. These often limited, hence:
- Development banks

# Development Banks

- They lend and invest, especially important after crisis
- They leverage lending to influence investment decisions and monitor the performance of borrowers.
- They undertake entrepreneurial functions, e.g, determining scale of investment, choice of technology and markets to be targeted and
- They offer extension functions, such as technical support.
- Stated otherwise, they are a component of the financial structure that can ensure that lending leads to productive investment that accelerates growth and makes such lending sustainable.

# Whither Liberalization?

- Success requires an established financial and regulatory infrastructure
- This takes time to develop
- Liberalize only when benefits unambiguous and no other sensible alternative
- Restrict liquid internationally integrated capital markets and pace of financial innovation, especially derivatives
- Protect specialized lending agencies, such as development banks.

# Basel III Accord and Microprudential Regulation

- Reforms will increase the minimum common equity requirement of banks from 2% to 4.5%.
- In addition, banks will be required to hold a capital conservation buffer of 2.5% to withstand future stress bringing the total requirements to 7%.
- Phased in by 2015.

# Basel III Accord

- Higher capital requirements for trading, derivative and securitization activities to be introduced at the end of 2011.
- Any bank that fails to keep above that buffer would have to curb payouts such as bonuses and dividends
- Seen as a minimum by some countries, e.g. Swiss asked UBS and CS to almost double this.
- Increased liquidity requirements from 2015.

## Table 1. Phase-In Arrangements for Capital and Liquidity Standards

(In percent, shading indicates transition - all dates are as of January 1)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage ratio	Supervisory monitoring		Parallel run 2013-17 Disclosure starts January 1, 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3.5	4.0	4.5	4.5	4.5	4.5	4.5
Capital conservation buffer						0.625	1.25	1.875	2.50
Minimum common equity plus capital conservation buffer			3.5	4.0	4.5	5.125	5.75	6.375	7.0
Phase-in deductions from CET1 (including amounts exceeding the limit for DTAs, MSRs, and financials)				20	40	60	80	100	100
Minimum Tier 1 capital			4.5	5.5	6.0	6.0	6.0	6.0	6.0
Minimum total capital			8.0	8.0	8.0	8.0	8.0	8.0	8.0
Minimum total capital plus conservation buffer			8.0	8.0	8.0	8.625	9.25	9.875	10.5
Capital instruments that no longer qualify as noncore Tier 1 capital or Tier 2 capital			Phased out over 10-year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				

# Critiques of Basel III Accord

- **Banks:**
- Lending will be curtailed, Cost of borrowing will rise
- **Others**
- Percentages correspond to "risk-weighted" asset values, not hard asset values
- Determined by ratings on various securities— which proved fundamentally unreliable and potentially fraudulent over the past decade.
- Also, banks themselves get to apply the risk-weightings to their assets
- Trade credits discriminated against whilst off balance sheet, especially hits developing countries.



# Critiques of Basel III Accord

- Basel III thus open to abuse, and will encourage new risks.
- Banks will apply inappropriate risk-weights to take on more leverage while conforming to the letter of the law
- Lehman's and Citigroup would have conformed
- Long time to implement
- Many banks already conform

# Impact of Basel III Accord

- BIS estimates domestic lending spreads will rise 15 basis points, costing 0.16% GDP per 1% increase in capital ratio
- BIS estimates lending volume will fall 1.4%, costing 0.32% GDP per 1% increase in capital ratio
- These are median results in a 4 year adjustment.
- Institute for International Finance, estimates 5 times higher for increased spreads and 8 times higher for reduced lending.

## Impact of Basel III Accord on Asia

- Countries, like China and Singapore, welcome Basel II as already meet or exceed requirements
- Thus better placed than Euro or NA banks in expanding credit to attract business
- China discourages link between banks and capital markets
- Has bad debt requirements, higher of 2.5% total loans or 150% non-performing loans
- Still concerns re property loans
- Hong Kong and Singapore worry about liquidity provisions of Basel III, insufficient govt. assets.

# An Asian Monetary Fund for Macro-prudential Management ?

- AMF conceived during 1997–1998 crisis.
- Quickly rejected by the IMF and the US Treasury.
- Why pursue it again?
  - healthier economic fundamentals
  - Bitter memories of harsh policies imposed by the IMF on Asian economies during the Asian Financial Crisis
  - current underrepresentation of Asia in the IMF
- First step towards AMF is the Chiang Mai Initiative (CMI)
- Bilateral swap agreements could be triggered to help member countries overcome liquidity problems in times of crisis.
- Participating countries include the 10 members of the ASEAN, China, Japan and Korea (collectively, ASEAN+3).

# An Asian Monetary Fund?

- In 2010, bilateral swap agreements, multilateralised under Chiang Mai Initiative Multilateralisation (CMIM).
- Reserves could be drawn on with just one agreement.
- In practice, CMIM pool not tapped during the Global Financial Crisis.
- Stand-by arrangements with the IMF required before CMIM funds could be utilised.
- Because CMIM lacked a surveillance function to guard against moral hazard.
- But requirement also meant that the CMIM would be an unpopular alternative of aid in times of stress.

# An Asian Monetary Fund?

- In 2011, ASEAN+3 Macroeconomic Research Office (AMRO) established for surveillance and due diligence.
- Beginning of an AMF?
- Beyond CMI, CMIM and AMRO, Asia's monetary policies converging , due to high Intra-regional trade.
- But, savings largely invested outside region. More financial integration for intra-regional investments?
- Possibility of an AMF now seems more likely.
- Need time for new AMRO competencies and greater financial integration before AMF a reality.

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THE End  
Questions?