Prudential Regulation: Balancing Growth and Stability

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A Regional Training Workshop on
“Beyond Inflation Targets:
Policy Options and Instruments for Sustaining Growth and Equitable Development”
Dhaka
19-22 December 2011
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-Liber al 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, 1800-2007

<table>
<thead>
<tr>
<th>Country/Economy</th>
<th>Time-frame</th>
<th>Non-performing Loans (% of total loans)</th>
<th>Fiscal Cost of Crisis (% of annual GDP)</th>
<th>Forgone Output (% of annual GDP)</th>
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<tbody>
<tr>
<td>Bangladesh</td>
<td>1985–1996</td>
<td>20</td>
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<td>China</td>
<td>1990–</td>
<td>50</td>
<td>47</td>
<td>39</td>
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<td>Indonesia</td>
<td>1997–2002</td>
<td>70</td>
<td>55</td>
<td>39</td>
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<td>Japan</td>
<td>1991–</td>
<td>35</td>
<td>24</td>
<td>48</td>
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<td>Korea</td>
<td>1997–2002</td>
<td>35</td>
<td>28</td>
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<td>Malaysia</td>
<td>1997–2001</td>
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<td>16</td>
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<td>Nepal</td>
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<td>Philippines</td>
<td>1983–1987</td>
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<td>Philippines</td>
<td>1998–</td>
<td>20</td>
<td>13</td>
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<td>Sri Lanka</td>
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<td>5</td>
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<td>Taiwan</td>
<td>1997–1998</td>
<td>26</td>
<td>12</td>
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<td>Thailand</td>
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<tr>
<td>Thailand</td>
<td>1997–2002</td>
<td>33</td>
<td>35</td>
<td>40</td>
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<td>Vietnam</td>
<td>1997–</td>
<td>18</td>
<td></td>
<td>23</td>
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<tr>
<td><strong>Average for Asia</strong> (14 episodes)</td>
<td>1980–2002</td>
<td>32</td>
<td>22</td>
<td>22</td>
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<tr>
<td><strong>Average for rest of world</strong> (97 episodes)</td>
<td>1980–2002</td>
<td>41</td>
<td>15</td>
<td>12</td>
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<tr>
<td>Country</td>
<td>Banking Crisis</td>
<td>Decontrol of Interest Rates</td>
<td>Abolishing Direct Credit</td>
<td>Increasing Competition</td>
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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.
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<tr>
<td>Minimum common equity capital ratio</td>
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<td>3.5</td>
<td>4.0</td>
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<td>Capital conservation buffer</td>
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<td>0.625</td>
<td>1.25</td>
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<td>Minimum common equity plus capital conservation buffer</td>
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<td></td>
<td>3.5</td>
<td>4.0</td>
<td>4.5</td>
<td>5.125</td>
<td>5.75</td>
<td>6.375</td>
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<td>Phase-in deductions from CETI (including amounts exceeding the limit for DTAs, MSRs, and financials)</td>
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<td>20</td>
<td>40</td>
<td>60</td>
<td>80</td>
<td>100</td>
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<td>Minimum Tier 1 capital</td>
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<td>4.5</td>
<td>5.5</td>
<td>6.0</td>
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<td>Minimum total capital</td>
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<tr>
<td>Minimum total capital plus conservation buffer</td>
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<td>8.0</td>
<td>8.0</td>
<td>8.0</td>
<td>8.625</td>
<td>9.25</td>
<td>9.875</td>
<td>10.5</td>
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<td>Capital instruments that no longer qualify as noncore Tier 1 capital or Tier 2 capital</td>
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<td>Liquidity coverage ratio</td>
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*Table 1. Phase-In Arrangements for Capital and Liquidity Standards*

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


• 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.
Select Bibliography


- Ilan Noy, 2005, ‘Banking Crises in East Asia: The Price Tag of Liberalization?’, Asia Pacific Issues, Analysis from the East-West Center No. 78, November.


THE End
Questions?