

Summary of the discussion

The discussion centred around the current experiences of advanced countries, in particular euro zone area, given the geographical intensity of stability issues in these economies. But, EMEs also have to address similar concerns especially being an integral part of the architecture for international cooperation. The discussions on macro and micro prudential measures as also macroeconomic measures for stability in the context of advanced economies are observed to be equally important for EMEs and there are valuable lessons to be drawn from the discussions.

Opening remarks by Anne Héritier Lachat

The lead discussant Anne Héritier Lachat, in her opening remarks chose to share the Swiss experience by providing a brief account of some of the recent initiatives taken post crisis in Switzerland. Switzerland has been moving really fast in implementing some of the key micro as well as macro prudential measures post-crisis. She elaborated on the measures that are already in place as also a few measures which are in the pipeline to strengthen prudential regulation of the Swiss banking sector from a systemic perspective. The new macro prudential measures primarily aim at reducing systemic risks and ensuring stability. There is no specific equity angle, but there is a desire to have also shareholders and creditors to bear the cost of a failure, besides tax payers.

Briefly explaining the institutional background, she mentioned that there are two major regulatory authorities. First is the Financial Markets Supervisory Authority (FINMA), playing the role of financial market supervisor and regulator. Second is the Swiss National Bank, a classical central bank which is also enjoined with stability as a mandate. There are two big systemic banks which still represent the size of about four times the GDP (pre crisis, it was more than ten times).

Explaining the present measures in place, she brought out several important features. First is the Too Big to fail regime adopted by Parliament, based on the recommendations of an expert group consisting of members drawn from regulators as also banks. It provides for a capital surcharge of 19% for systemic banks (10% CET 1 plus 9%) for better capital quality. (It was added at a later stage that leverage ratio has also been introduced for the two large banks and for other banks, Basel III norms would become applicable) The resolution regime would be a national regime, though some cross border spill overs might be taken into account. On the governance side, SNB after consultation with FINMA will identify and designate the banks which are of systemic importance. SNB's decision by law can be challenged in judicial court. FINMA will implement all measures, both capital requirement and the resolution regime.

Secondly, a general higher capital requirement has been put in place for all banks under Basel pillar 2, which helps to strengthen the whole regime.

Thirdly, banks are being brought under different categories for the purpose of supervision with varied intensity, based upon their size and risks, to achieve supervisory efficiency.

Finally, the FINMA, SNB and the Ministry of Finance have entered into a MoU, to effectively deal with crisis management; it also provides for regular discussions on macro prudential and macroeconomic aspects and sharing and exchange of information.

There are two measures in the pipeline which will come into force from the first quarter of 2012. First are the new capital rules on mortgages, not LTV requirements, but higher capital for riskier loans. Second, a measure which is still in design stage is a counter cyclical buffer, drawing from Basel III as a model. That will be applicable only to mortgages. The buffer will be activated by the government upon proposal of the SNB after consultation with FINMA. The buffer will be limited up to 2.5% and FINMA will implement the rules.

She made some observations and raised a few related questions before concluding her remarks. First, regulation is only a tool and it is necessary to strengthen supervision. There should be coordination between the regulator or the central bank and the supervisory authority even when these two functions are integrated. Secondly, will central banks lose some of their independence? Third, arrangement for gathering and sharing of information, even if it is supervisory information is very important. Fourth are

the issue and clear establishment of accountability. Finally, efforts should be made to quantify the costs and benefits of regulatory measures from the angles of growth and equity.

Discussion

While macro prudential and monetary policies have to work together, with two separate instruments and targets, the policies get entangled and assume complexity. The central banks being the most independent of political cycles are placed best in implementing prudential measures. Most of the measures proposed are micro prudential and strong exercise of supervision is required to implement them. Here again, it would be desirable to keep the supervisory function vested with the central bank. When decisions relating macro prudential and monetary policy aspects may have to be taken jointly, it is necessary to have a hierarchy of objectives.

On the governance issue, it was urged that the level of cooperation that is seen at the international level to achieve financial stability should be reflected equally at the domestic level. For instance, in Turkey there is yet no consensus about the systemic risk. A Financial Stability Council has been set up in Turkey to achieve and ensure such cooperation among regulators and the government.

The issue relating to assessment of risk on sovereign debt holdings by the banking system was discussed at length. It was clarified that did not mean marking to market of securities in held to maturity portfolio. That would really mean higher capital depending upon assigning a probability of default for sovereign debt, even in the absence of a default. Banks cannot assess risks purely based on current information which may be inadequate. However, the real issue in the current context is how quickly the sovereigns really acquire their risk free status back.

Another question addressed related to the short term impact on credit growth and economic recovery in Eurozone area consequent to implementation of the recent comprehensive package. The package has three pillars, namely, recapitalisation of banks including those in Spain, sorting out of the Greek problem and leveraging on the EFSF. To be effective, all these three pillars should be implemented quickly. Yet another issue was how the macro prudential and counter cyclical buffers will be operational in respect of shadow banking systems and also in respect of complex derivative products. Also, if products such as credit cards by retail chains are left unregulated, that could lead to regulatory arbitrage. While it is true that a part of the shadow banking system falls outside the purview of regulation, it was felt that the special purpose vehicles carried in off-balance sheet form that led to destabilisation of the banking system. Regulation should address this issue.