High-level policy panel on financial stability issues

Tarisa Watanagase[1]

Governors, distinguished colleagues,

First of all, let me congratulate the Asian Research Programme for this excellent set of policy-oriented research papers, which should make a valuable contribution to resolving our policy challenges going forward.

Foremost on our minds are a number of financial stability issues that have gained renewed urgency with the current global crisis. In response, we see some key reform agendas emerging, in certain G20 recommendations, for example, with proposals for the reform momentum to be propelled by mechanisms such as the International Monetary Fund and World Bank's Financial Sector Assessment Program. This is very important as it would be a key way of addressing weaknesses in major markets and restoring stability to the global financial system.

However, it is also important for emerging markets to set our reform agendas based on the priority of our policy challenges, and these may differ from those of the developed economies, due to the differences in the structure and vulnerability of our financial systems.

The one key common challenge we share is the challenge of developing and implementing a macroprudential policy framework to safeguard financial system stability. In the context of emerging markets, where policy making is under the environment of rather imperfect information, here, the key hurdles are rather significant and include theoretical, empirical, and infrastructural challenges. This is why the pooling of our scarce technical and research resources with those of the BIS can make a major contribution at this important juncture.

Thus, I believe the key strategic questions we face are:

- how best to approach the financial stability challenges?
- and how best can we direct, as well as prioritise, our regulatory agenda, particularly areas of macroprudential oversight?

Now, as to the first question: how should we approach financial stability problems?

The oscillation between deregulation and re-regulation is familiar, as is the classic debate over the rationale for regulation.

The swing of the pendulum is driven by the key goals of regulation, which are to ensure consumer protection, market integrity and system stability.

The direction and amplitude of the swing is propelled by the gap created by market failures. That is, the gap between the current state of the market – in terms of its stability, integrity and fair consumer treatment – with the market conditions desired by society. Given the extent of the current global crisis, the gap as perceived by society is vast, and thus the demand for strong and comprehensive reforms tends to magnify the swing.

What we really need here, I believe, is to foster the foundation for a "balance of approach" in our regulation. This can happen in a number of ways.

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[1] Governor of Bank of Thailand

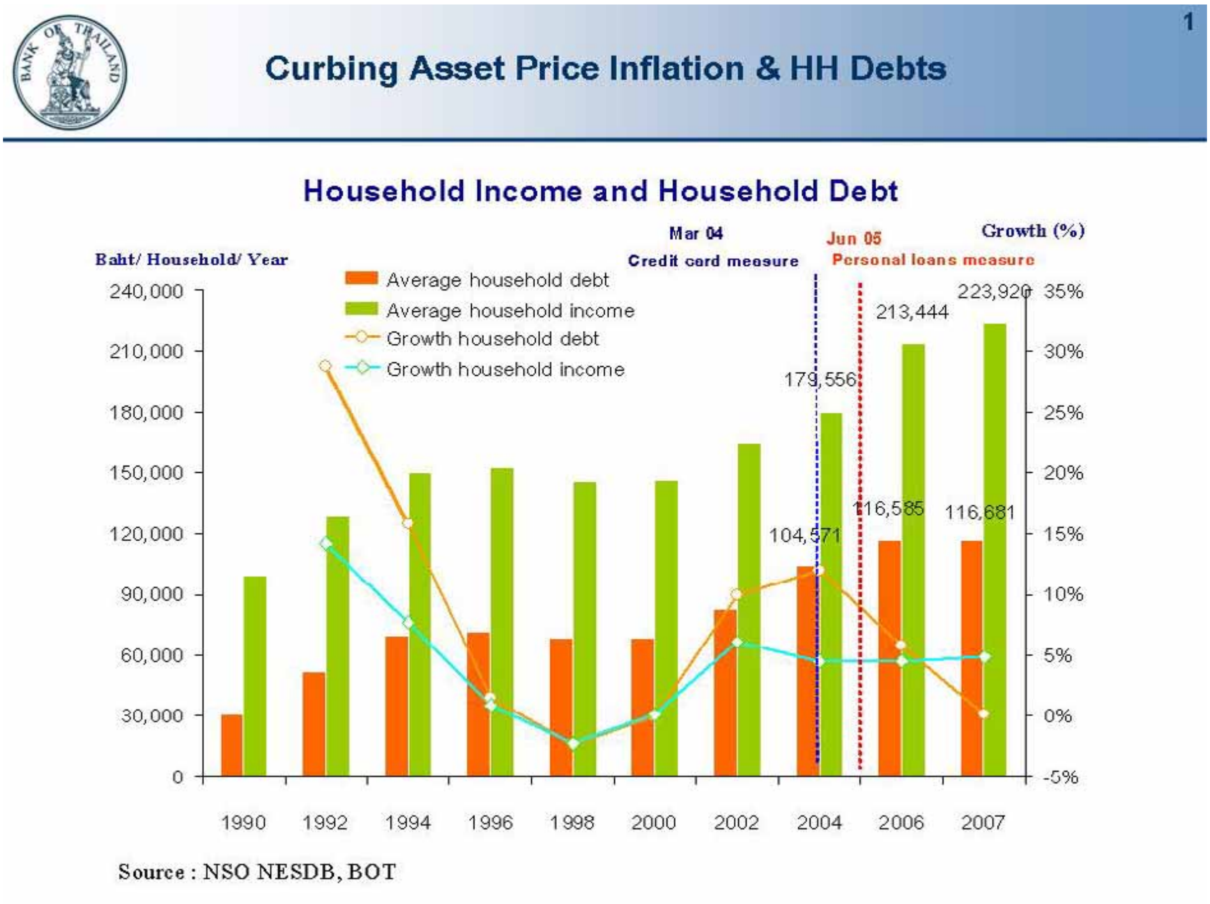
First, the current "natural" swing is toward tighter regulatory oversight. To an extent we can already observe such a trend already in the United States and the European Union. Here, I agree with Professor Goodhart's astute observation. If the so-called Anglo-Saxon model has weaknesses as highlighted by this crisis, then perhaps we may benefit from adopting some of the features of what Professor Goodhart refers to as the Asian model.

Second, we should also avoid the tendency to swing too far in the opposite direction, by making a conscious commitment to a balanced middle path.

Third, we should utilise a mixed approach, that is remain agile and flexible with our policy framework, so that we can efficiently address the emerging vulnerabilities, which are changing dynamically.

In the case of the Bank of Thailand, we combine market-oriented microprudential risk-based supervision with macroprudential regulatory measures to oversee systemic risk. Such macroprudential measures include measures to prevent asset bubbles by capping loan-to-value ratios for high-value residential real-estate loans, and measures to contain household debt by toughening credit card issuance practice for low-income earners.

From the graph shown below, the macroprudential measures have been instrumental in preventing the build-up of vulnerability.



So what could help us maintain a balanced approach to regulation. The key is to refine our policy debate so that it can respond to the highly dynamic, interconnected and globally systemic relationships that are the key features of the global financial market.

To help us refine our policy question, we could focus on the causes and impact of market failures, be they externalities, imperfect information or agency problems, as familiar from economic theory, and we could seek to apply efficient policy tools to each type of market failure.

In this light, the relevant questions for us today would be

- What are the macroprudential policy measures that we can suitably implement?
- How to combine the macroprudential framework with microprudential and monetary policy? The challenges here include the technical questions of policy calibration, as well as the governance question of the policymaker.
- In practice of course, policy is set in a dynamic environment, so "sufficient" policy calibration is often a luxury. Rather, the challenge is how to "lean against the wind" without the benefit of a more precise policy calibration. Here perhaps we can benefit from having a sufficiently flexible and holistic approach that combines policy calibration with moral suasion and utilises the impact of signalling, as well as using incremental and gradual measures that allow new information to be factored into policy setting. Therefore, the challenge is as much in the process and governance aspects as in quantitative modelling.

Of course, we must at the same time continue to forge on with work on how to seek a balance between the need for measures of capital requirement to be risk-sensitive, but avoid the negative consequences of procyclicality.

Of course, with the cross-border transmission of today's systemic risk, as demonstrated by the work by Kim, Loretan and Remolona, we need to think of a process to better internalise and manage such externality for emerging markets. One of the ways to do this is to incorporate emerging market key agendas in global regulatory reforms.

Thus, we should also foster a "balanced agenda" in regulatory reform, especially in the area of home-host regulators, where the systemic impact on host economies should be a key factor shaping the relationship and degree of coordination.

On the reform agenda, we support the work of the G20, but we should also emphasise our own set of common priorities.

In terms of research, I believe the BIS Asian Research Programme can be instrumental in helping us to operationalise these reforms in the region. I believe that we are on the right path, with valuable work such as those by Eloisa Glindro and her colleagues on asset prices, but I would also urge strengthening the programme in some critical research areas.

These include:

- the means to develop through-the-cycle credit risk data with a view to building up provisioning buffers;
- research on principles on how to improve Pillar 2 and ICAAP in standardised approach banks using the standardised approach to adequately take into account the cyclicality of credit risk data when building capital buffers.
  - Allow me to elaborate on this: currently, in emerging markets such as Thailand, most banks have implemented the Basel II capital framework using the standardised approach. Under Pillar 2, banks should take account of cyclicality in their capital buffer. However, given that the standardised approach banks do not have as sophisticated data analysis facilities as the internal ratings-based banks, there are no clear standards on how to analyse through-the-cycle risk data in terms of either practice or supervisor expectation. Therefore, it will be of great benefit if there could be research and a recommendation on this issue. Further detailed guidelines on ICAAP methodology and/or principles should also be considered.

– It is still unclear how to incorporate history and structural breaks in through-the-cycle data. One way to address this issue is through stress testing. Although there is some methodology and guidance on incorporating stress testing result into ICAAP, further details could be added to operationalise stress testing results in a consistent and sound manner.

Finally, we think that credit risk data is useful not only for analysing capital buffer but also for loan underwriting practices. It woud be beneficial to encourage banks' in strengthening their capacity in credit risk data collection and analysis as a foundation for macroprudential objectives. This is not much discussed in the international forum but is an especially challenging issue, given the poor data history and structural breaks that arise from the crisis of the previous decade and also from the current crisis and weakness in financial infrastructure.

Thus, the key output of the policy research should include not only research on quantitative and calibration technique, but also organisational capacity-building principles, including those related to credit risk data-pooling with a view to strengthening loan underwriting.

In closing, I welcome the valuable work done by the BIS Asian Research Programme, and I look forward to its potential contribution to our policy framework in the region.

Thank you for you attention.