Macroprudential frameworks, implementation, and communication strategies – The Philippines

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Abstract

The Bangko Sentral ng Pilipinas (BSP) plays a key role in maintaining the financial system stability of the Philippines. While its primary objective is price stability, the BSP's clear monetary policy and financial stability frameworks have ensured that interactions between the two will remain complementary. The paper underscores that the use of macroprudential policy as well as various surveillance and analytical tools to promote financial stability has allowed the BSP to keep monetary policy focused on its primary objective of maintaining price stability. Furthermore, the paper emphasises that maintaining financial stability is not the sole task of the BSP, but is a shared responsibility by relevant segments of the financial system. As such, apart from establishing an internal Financial Stability Committee (FSC), the BSP has initiated the creation of an inter-agency body, the Financial Stability Coordination Council (FSCC), which involves the regulators of insurance companies and non-financial corporates, as well as the finance department and deposit insurance agency. Moreover, the paper highlights the importance of having a sound communication strategy, not only for monetary policy, but also for financial stability.

Keywords: financial stability, macroprudential policy, communication strategy, The Philippines

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Macroprudential framework

For the BSP, the use of macroprudential tools to promote financial stability has allowed it to keep monetary policy focused on its primary objective of maintaining price stability. This has helped enhance monetary policy's credibility in maintaining price stability. Indeed, in the past few years, the BSP has responded to inflationary pressures with measured changes in the policy rate, which have allowed the BSP to better manage expectations, avoid policy surprises, and signal the BSP's commitment to its price stability mandate.

Moreover, the BSP recognises that monetary policy and financial stability policy interact and influence one another. Monetary policy has side effects that can affect financial stability even when it pursues its own objective. For instance, accommodative monetary policy may give incentives for banks to over-leverage and take on more risk, while tight monetary policy may adversely affect borrowers' capacity to pay, which can lead to high default rates in the financial system. Experience has also shown that interest rate changes affect capital flows, which, in turn, can lead to excessive swings in the exchange rate and result in destabilising effects on the financial system.

Meanwhile, financial stability is essential for an effective monetary policy since the fragility of the financial sector can affect the transmission of monetary policy to the real economy. For instance, macroprudential measures that attempt to constrain borrowing in one or more sectors of the economy to prevent over-concentration of risk will affect expenditure in those sectors. Hence, even when monetary policy is accommodative, macroprudential measures can have an offsetting effect on economic activity on specific sectors and on overall economic output.

Such side effects imply that central banks need to take into account policy interactions. Claessens and Valencia (2013) argue that, if macroprudential policies have strong effects on output, more accommodative monetary policy can offset these effects as necessary. If changes in the monetary stance increase incentives to take too much risk, the relevant macroprudential policies should be tightened. Table 1 lists the appropriate conditions under which monetary policy and macroprudential policy should be used.

Summary of the appropriate use of monetary policy and macroprudential policy			Table 1
Scenario	Monetary policy	Macroprudential policy	Remarks
Maintaining macroeconomic stability	✓	✓	Should be complementary when there is financial instability During normal times, a combination of monetary policy and macroprudential policy will only provide modest benefits over monetary policy alone
Financial stability concerns following a financial shock	✓	✓	Use mainly macroprudential policy and less monetary policy
Productivity shock	✓	✓	Appropriate mix depends on strength and expected persistence of the shock, the riskiness of balance sheets, including buffers and leverage
Aggregate demand shock	✓		Monetary policy is optimal if it could stabilise both inflation and output
	✓	✓	Should be used together if stabilising inflation comes at the cost of lost output and when lending imposes a systemic risk externality
Only distortions are price rigidities or rigidities in non-financial (real) sector	✓		Ideal setting: policies are operating perfectly, no institutional or political economy constraints
Only financial distortions (eg boom in housing markets, high private sector leverage)		✓	Ideal setting: policies are operating perfectly, no institutional or political economy constraints

Sources: Angelini et al (2011); IMF (2013).

For the Philippines, inflation pressures and interest rates have remained relatively low and stable in recent years.[2] The economy has also expanded at a robust pace.[3] The low and stable inflation, meanwhile, has fuelled credit growth, particularly in the real estate sector. While these developments are favourable for the economy, these factors could also possibly lead to financial market imbalances.

For instance, an upturn in the interest rate trend can adversely affect the debt-servicing capacity of real estate borrowers. With the growing exposure of the banking sector to the real estate sector, the BSP has employed macroprudential measures to guard against systemic financial stability risks that may arise from the sector.[4] One of the most recent measures implemented is the Real Estate Stress Test (REST) limit for

[2] For the past three years, the inflation rate has averaged 2.4%.

[3] For the past three years, real GDP growth rate has averaged 6.4%.

[4] These measures include (a) expanded reporting requirements for banks on their exposure to the property sector; (b) a requirement for all universal/commercial banks and thrift banks to submit a Quarterly Report on Residential Real Estate Loans (RRELs) granted by banks to provide information for the generation of a residential real estate price index (RREPI), which is a valuable tool in assessing real estate and credit market conditions; and (c) the Real Estate Stress Test (REST) limit for real estate exposures.

real estate exposures,[5] where banks are required to maintain a Common Equity Tier 1 capital ratio of 6% and a minimum risk-based capital adequacy ratio of 10%, assuming a 25% write-off of exposure to the real estate sector. The macroprudential measures implemented by the BSP are supported by its risk-based, consolidated supervision, sound regulatory framework and effective enforcement.

The BSP has a wide array of macroprudential measures to respond to the challenges of maintaining financial stability. Macroprudential policies are already in place (ex ante) to contain the risk-taking behaviour of financial intermediaries in "good times".[6] And, as in the real estate sector, the BSP also stands ready to deploy appropriately designed and targeted macroprudential measures to prevent excesses in specific markets that are prone to price misalignments. In addition, the BSP has predeployed macroprudential measures that can be adjusted in a countercyclical manner to prevent financial imbalances. Examples include caps on loan-to-value ratios, general loan loss provisioning, single borrower limits, concentration limits, limits on open FX positions, asset cover for banks' FCDU liabilities, and liquidity measures.[7]

Apart from macroprudential tools, the BSP uses various surveillance and analytical tools to ensure the overall safety and soundness of banks and other financial institutions under its supervision. These tools consist of rating systems, early warning systems (for currency crisis and external debt crisis), stress tests, network analysis and various periodic reports and publications. The set of tools for measuring vulnerabilities serves as a complementary instrument that provides analytical discipline and rigour in the policy decision-making processes. These tools are also continuously being studied and reviewed to further improve the BSP's tool kit in response to latest developments and emerging issues. Overall, these indicators are used to identify financial market vulnerabilities. They provide insights that lead to collective and rigorous discussions among decision-makers, giving them the basis for objective and informed judgments.

These macroprudential measures and the various surveillance and analytical tools are subject to careful study and calibration. While the choice of different tools has increasingly relied on quantitative methods, judgment maintains a primary role.[8] For one, quantitative approaches may not be able to perfectly capture the influence of a policy on market participants' behaviour and expectations. In addition, judgment is required as to when a gradual or rapid approach must be taken to manage risks in the financial system.

[5] REST was activated on 27 June 2014.

[6] Frait and Komárková (2011) identify the "good times" as the upturn in the financial cycle, when systemic risk tends to build up. In such a period, the response should be to strengthen the resilience of the financial system through the use of preventive measures (such as caps on open FX exposures and loan-to-value ratios) and the creation of buffers (such as increasing capital requirements).

[7] During the 2008–09 global financial crisis, the BSP deployed liquidity measures, such as a US dollar repo facility promotion on the use of banks' hedging facilities, and increased the budget for Exporters' Dollar and Yen Rediscounting Facility (EDYRF) measures to address the dollar liquidity needs of banks and firms. In 2008, when the facility was introduced, a total of US$ 43 million was made available at a rate of 4.79%. In 2009, only US$ 34 million was made available at 4.5%. No funds were made available in subsequent years.

[8] International Monetary Fund-Financial Stability Board-Bank for International Settlements (IMF-FSB-BIS) (2016).

In the BSP, the Monetary Board makes the final judgment as to what policy measures, whether monetary or supervisory, including macroprudential, should be implemented. The Monetary Board has seven members appointed by the President of the Philippines. Apart from the BSP Governor, who chairs the Board, it comprises five members from the private sector and a member of the Cabinet. All members of the Board have recognised competence in social and economic disciplines.[9] This helps ensure that all policies implemented by the BSP are judiciously formulated.

Every week, the Monetary Board and the Deputy Governors of the BSP meet to discuss monetary, supervisory and macroprudential issues and other matters. Since the Deputy Governors of the Monetary Stability Sector and the Supervision and Examination Sector both attend the weekly meeting, any inconsistency in regulations can be discussed. Furthermore, a representative from the national government is also a member of the Monetary Board. Hence, any conflict with fiscal policies can be immediately raised during the meeting.

In addition, the BSP has an internal committee – the Financial Stability Committee (FSC), established in 2010 to adequately monitor and mitigate the build-up of systemic risks in the financial system. As such, the FSC has the authority to propose to the Monetary Board any macroprudential measures that it deems appropriate to maintain the robustness of the financial system. The Committee currently comprises five workstreams, namely, corporate leverage, shadow banking/real estate, capital flows, financial market infrastructures/intra-day liquidity, and regional integration. An offshoot of this committee is the Office of Systemic Risk Management (OSRM), recently set up as a distinct office in the BSP. The establishment of the OSRM strengthens the BSP's capacity to continuously monitor and assess financial system vulnerabilities. The workstreams and the OSRM regularly report to the FSC Executive Committee, which is chaired by the BSP Governor and comprises high-level BSP officials.

Coordination with financial system regulators. Aside from the BSP, there are other financial system regulators in the Philippines. The Insurance Commission (IC) regulates insurance companies, and the Securities and Exchange Commission (SEC) regulates corporates, capital market participants, the securities and investment instruments market, and the investing public. The division of responsibilities across different regulators allows for a more focused supervision of different types of financial institution. Nonetheless, the BSP recognises that systemic stability regulation needs to involve all major stakeholders, including the central bank, financial supervisor, finance ministry and deposit insurance agency. Thus, in 2011, at the initiative of the BSP, the Financial Stability Coordination Council (FSCC) was created.[10] The FSCC brings together the BSP, IC, SEC, Philippine Deposit Insurance Corporation (PDIC) and the Department of Finance (DOF). Through the FSCC, the different agencies are able to take a more comprehensive view of the financial system, thus enhancing the understanding and implementation of macroprudential policies. Possible conflicts among the regulations of these agencies are resolved through discussion. The FSCC meets every quarter, which allows the agency heads to settle any disagreements over regulations in the financial system.

[9] This is one of the qualifications of a member of the Monetary Board, as stated in Chapter I, Article II, Section 8 of The New Central Bank Act (RA 7653).

[10] Nonetheless, the Memorandum of Agreement (MOA) formalising the creation of the FSCC was signed only on 29 January 2014.

Moreover, central bank coordination with other financial sector authorities is essential because regulators of different segments of the financial system may operate under different sets of rules, principles and standards, which may result in different qualities of supervision and appreciation of financial stability. In particular, the technical capacity of different regulators in assessing the economic and financial environment as well as detecting emerging risks may not be aligned. Thus, apart from information-sharing and capacity-building, coordination across financial sector authorities allows these differences to be aligned.

In addition, the FSCC has provided a venue where the BSP can motivate other regulators to carry out reforms and macroprudential policies to safeguard financial system stability. More importantly, the creation of the FSCC emphasised that maintaining financial stability is not the sole responsibility of the central bank, but is one that must be shared by all segments of the financial system.

The FSCC has five working groups (WG) that focus on specific concerns. The Corporate Leverage WG looks at domestic and cross-border debt exposures of non-financial corporations; the Shadow Banking-Real Estate WG focuses on real estate activities that are beyond the purview of the financial system regulators; the Capital Market Development WG looks at issues on pricing and valuation in capital and contingent markets as well as concerns on financial market infrastructure; the Financial Crisis Management and Resolution WG focuses on recovery and resolution strategies; and the Communication WG that manages financial stability-related issues.

The FSCC also collaborates with other industry sectors on a broad array of developments that may impinge on financial stability. For instance, in the real estate sector, developers have extended in-house financing to buyers through contract-to-sell agreements. Such a financial service is offered outside the formal banking sector, is not subject to regulatory oversight, and thus may be classified as a form of shadow banking. To address the possible adverse implications, the FSCC has signed a memorandum of agreement with the Housing and Land Use Regulatory Board to facilitate information-sharing among the agencies to better understand the interconnectedness and to mitigate the build-up of systemic risks arising from the activities of the real estate sector.

More forward-looking analytics to respond to prospective risks is needed. Given the greater efforts to enhance financial stability, there is scope to develop the construction of more forward-looking indicators to assess vulnerabilities well before the emergence of stress. For instance, a forward-looking index could be developed to assess potential stress in various financial markets (currency, equities, bonds etc). In addition, it would be useful to develop indicators to analyse developments in the banking sector alongside those among non-bank financial institutions as well as non-financial corporations. Likewise, with intensifying efforts towards further regional financial integration, there is a need to develop tools to monitor possible risks arising from operations of foreign banks' subsidiaries and branches in the domestic financial sector as well as from operations of local banks abroad. Indicators could also be developed to better assess how developments in the financial sector affect the outlook for the real sector. In short, being forward-looking and responsive to prospective risks is key to the timely and successful implementation of macroprudential measures.

Communication strategies

There is a broad consensus among economists that a clear and well communicated central bank monetary policy framework confers benefits (Levin (2014)). For one, clarity about the monetary policy framework strengthens the effectiveness of the monetary transmission mechanism by enhancing the public's understanding of how the policy stance is likely to evolve in response to economic and financial conditions. This facilitates informed decision-making by households and businesses and reduces economic and financial uncertainty. In addition, transparency about monetary policy is essential for maintaining the central bank's operational independence, thereby enabling its policy decisions to remain insulated from political pressures.[11] Moreover, communicating the policy stance through various communication tools (such as periodic reports, policy statements and meeting records) not only helps inform the public of the policy stance but creates a commitment to take action. This promotes the effective pursuit of the monetary policy objective. In some cases, communication tools have been required by law as accountability devices.[12]

Communication as a useful instrument in its own right (BIS (2016)). In recent years, the essential role of communication in the context of financial stability has gained more attention and thought. While there are parallels between monetary policy and financial stability communication, there are also some important differences that can make the design of an effective communication strategy for financial stability particularly challenging. In particular, using communication as a tool to convey risk assessments without disclosing a particular policy action could have greater impact but also poses greater challenges. Risk communication in early stages of a credit cycle is likely to have a small impact since agents are inclined to continue proven profitable strategies. However, an abrupt adjustment by stakeholders when warnings are issued in situations where risks are elevated may either alleviate or exacerbate financial stability concerns.[13] In this case, communication would therefore appear to be easier to control and is hence a more useful instrument in its own right.

As with monetary policy, clear communication can enhance the impact of financial stability measures. Timely and effective central bank communication can help markets and the public anticipate the policy response to signs of developing risks and, thus, discourage behaviour that could imperil financial stability.[14] It can also strengthen central bank credibility in macroprudential surveillance and policy.[15] Furthermore, financial stability communication can help build political and public support for any actions that may be needed but at the same time, be unpopular with the public. It can likewise help manage public expectations about what can be

[11] Levin (2014).

[12] IMF-FSB-BIS (2016).

[13] BIS Report of the Study Group on the nexus of objective-setting and communication of macroprudential policies and the relationship with monetary policy (2016).

[14] Geraats (2009).

[15] Credibility in macroprudential policy can reinforce credibility in monetary policy and vice versa. Absence of credibility in either policy area can be transmitted to the other.

achieved with macroprudential policies.[16] Meyersson and Karlberg (2012) stressed that communication is an important tool that central banks can use to avert a crisis, specifically by providing information about its assessment of risks and about the measures it sees as necessary to reduce those risks.[17]

Nonetheless, there are challenges in central bank financial stability communication. There may be a case for limiting the extent of disclosure if the release of particular information may potentially be market-moving and harmful. For instance, improper communication of specific potential financial system vulnerabilities may trigger a panic. This suggests that the central bank's financial stability communication strategy needs to be well crafted and well timed. This requires a fine balancing act – keeping market participants and the public informed about potential financial stability risks, advising caution and promoting mitigating action, yet without causing panic. Moreover, central banks must avoid inadvertently disclosing private information that may cause unwarranted concern and speculation about the state of individual financial institutions.[18]

Another important challenge for financial stability communication is the absence of a single, quantifiable objective for financial stability that is as precise, clear and easily understood as that for price stability (Vayid (2013)). In addition, there is no primary instrument for limiting systemic risk, akin to the policy interest rate under conventional monetary policy. Instead, there is a wide range of financial stability indicators (for instance, non-performing-to-total loans ratio, credit-to-GDP gap, return on assets, foreign currency-denominated-to-total loans ratio, and capital adequacy ratio, among others) and regulatory tools (broadly classified as credit-, liquidity-, and capital-related).[19] Moreover, financial stability responsibilities are often assigned to several different government authorities. Hence, unlike monetary policy where the central bank has sole responsibility, in financial stability, the responsibility is often shared with other national authorities.[20]

For the BSP, clear, transparent and timely communication is considered an integral component of its monetary policy framework. Communication and interaction with the public, the media and the markets have enhanced the credibility, predictability and effectiveness of the BSP's monetary policy. Communication has served not only as a means to convey information about monetary policy but also as a policy tool for the central bank. Clearly conveying its monetary policy to the public has improved its predictability, and, in turn, the effectiveness of monetary policy. In addition, it has made the BSP more accountable for its actions and has ensured consistent policy decisions over time.[21]

The BSP has a wide array of monetary policy communication tools, including, regular media releases and briefings, meetings with stakeholders, press conferences, and publications. Highlights of the Monetary Board meeting on the monetary policy

[16] IMF-FSB-BIS (2016).

[17] Meyersson and Karlberg (2012).

[18] Born, Ehrmann and Fratzscher (2011).

[19] Lee, Asuncion and Kim (2015).

[20] Vayid (2013).

[21] Fermo and Silva (2012).

stance, which is conducted every four weeks, is released publicly through the website of the BSP. The *Inflation Report* is also published quarterly, with an accompanying press conference, as part of the BSP's transparency mechanism under inflation targeting and to convey to the public the overall rationale and analysis behind the BSP's decision-making on monetary policy. The BSP Governor also issues an Open Letter to the President of the Philippines if the BSP fails to achieve the inflation target, outlining the reasons why actual inflation did not fall within the target, along with the steps that will be taken to bring inflation towards the target.[22] Meanwhile, the *BSP Annual Report* is submitted annually to the President of the Philippines and the Congress highlighting the major developments in the Philippine economy and the key activities, policies and operations of the BSP during the year. An *Annual Report for the Layman* is also published, using more accessible terminology.

Similarly, the BSP considers clear, transparent and timely communication essential for its financial stability framework. Financial system vulnerabilities and BSP actions or responses to them are primarily communicated through media releases and interviews conducted by the media, credit rating agencies and investment houses. Supervisory and macroprudential regulations, procedural requirements, explanations, and interpretations of provisions of laws or of BSP circulars are made publicly available on the BSP website. While it is not the BSP's practice to communicate to the public the prudential tools that were considered but not chosen to address vulnerabilities, the Bank carefully studies every measure that it considers. For instance, in communicating the implementation of the REST limit, the BSP reached out to entities outside its regulatory purview such as real estate developers and government housing agencies to explain the need for such a policy tool as a pre-emptive measure to mitigate the impact of a real estate bubble on the economy. Speeches were also made by senior management before implementation to float the idea of the REST measure as a way to test industry/market reaction.

In addition to media releases, interviews and speeches, BSP prudential regulations are communicated through meetings with stakeholders and regular publications. The BSP-Bank Supervision Policy Committee regularly conducts meetings with 15 industry associations for the continuous rationalisation of regulations so that supervisory policy remains relevant and responsive. The publicly available *Quarterly Report on Economic and Financial Developm*ent outlines the major developments in the real, monetary and fiscal sectors of the Philippine economy. In addition, the *Status Report on the Philippine Financial System* is published biannually to provide a comprehensive assessment of major developments in the Philippine financial system during the semester. The *Financial Stability Report*, which contains the BSP FSC's assessment of market risks and policy responses is currently only circulated among the top management and senior officials of the BSP but it too will soon be made available to the public.

Within the BSP, a communication work stream exists under the FSC to coordinate the communication approach for price and financial stability. A similar communication working group was also created under the FSCC to harmonise financial stability initiatives and messaging among the country's financial regulators and its fiscal authority. The BSP has likewise initiated within the FSCC a communication framework that is aimed at sensitising key stakeholders to financial

[22] Open Letters to the President have been issued on 16 January 2004, 18 January 2005, 25 January 2006, 19 January 2007, 14 January 2008, 26 January 2009, 28 January 2016, and 20 January 2017.

stability issues. The framework is designed to convey financial stability matters in easily comprensible language to staff of FSCC member agencies, financial sector participants, financial consumers and the general public. The communication framework is seen to enhance both the understanding and implementation of macroprudential policies.

The BSP also has an Enterprise-Wide Communication Plan that establishes its external communication policies and protocols. A central feature is a set of communication strategies to effectively engage stakeholders through a clear and transparent communication policy. To implement the strategies, the Plan has three tracks: Advocacy Management, Issue Management, and Media Management. The Advocacy Management Track handles various advocacies of the Bank that have target-specific audiences and unique goals such as financial inclusion, microfinance, anti-money laundering, financial education and consumer protection, and the remittance environment for overseas Filipinos. The Issue Management Track handles high-profile concerns that require expert handling because of their sensitivity to public opinion such as regional integration, FX liberalisation, monetary and inflation management, and financial stability. The Media Management Track handles the requirements of the media and guidelines on how to deal with the traditional channels (print, television and radio) and with the new media (social media).

Moreover, to some extent, macroprudential policy finds itself in the same situation as monetary policy a few decades ago when central banks began developing frameworks for making the formulation of inflation targeting more transparent and accountable. Designing a similarly "systemic" policy framework for financial stability is critically important.[23]

Nonetheless, Filardo and Guinigundo (2008) emphasised that no matter how carefully a central bank has crafted its message with respect to substance and timing, scope will remain for some miscommunication. For example, signals by the central bank can be subject to misinterpretation by the recipients, especially when different groups of recipients are seeking different types of information. Moreover, differences in recipients' abilities to absorb and interpret information and different levels of interest in the details of the policy may reduce the effectiveness of a one-size-fits-all communication strategy. In particular, the recipients of the messages are not all passive consumers and transmitters of information; some, such as the press, may have their own agenda when passing on the information to various audiences. Thus, increasing the level of economic and financial literacy in the population at large would definitely go a long way in helping central banks better communicate with the public. As such, the BSP has an Economic and Financial Learning Program (EFLP), which aims to promote economic and financial learning so that the public can acquire knowledge and develop skills needed to make informed economic and financial decisions. Since its launch in 2010, the EFLP has been conducted 44 times.[24] In this way, the public can become better partners of the BSP in ensuring the effectiveness of its monetary, financial and banking policies.

In conclusion, the BSP believes that it has a central role in maintaining financial stability. While its primary objective is price stability, the clear monetary policy framework and financial stability framework of the BSP have ensured that interactions

[23] BIS (2016).

[24] Data as of 7 March 2017.

between the two will not be discordant. In addition, the BSP emphasises that maintaining financial stability is not the sole task of the central bank, but is a responsibility that must be shared by all segments of the financial system. Finally, the BSP recognises the importance of having a well crafted and well timed communication strategy not just for monetary policy but also for financial stability.

Moving forward, essential issues remain. In the attempt to increase the resilience of the financial system and prevent the build-up of financial imbalances, various macroprudential tools have been deployed. In this process, macroprudential policy faces important trade-offs between systemic risk and financial intermediation, and ultimately economic growth. The mechanisms of the trade-offs are currently not well understood. Furthermore, the transmission mechanism of macroprudential policy is complex and therefore subject to considerable uncertainty. Uncertainties about the transmission channels may not only create difficulties in assessing the effectiveness of a particular macroprudential instrument, but they can also create the potential for unintended consequences. Moreover, the precise timing of activating or deactivating macroprudential instruments remains unclear. Theoretical, empirical and policy research on these issues, among others, is bound to provide a considerable amount of benefit to macroprudential policymaking.

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