Kiyohiko G Nishimura: Macro-prudential policy from an Asian perspective

Speech by Mr Kiyohiko G Nishimura, Deputy Governor of the Bank of Japan, at the high-level seminar on macro-prudential policies, Shanghai, 18 October 2010.

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I am honored to have been invited to this prestigious Conference, and particularly thrilled to have been given the opportunity to talk about macro-prudential policy from an Asian, or more specifically, Japanese perspective. This perspective is important in considering macroeconomic policy in general, and, in my opinion, all the more so given the current international discussions of regulatory reforms after the global financial crisis. In this short presentation, I will explain how the Bank of Japan has been actually implementing macro-prudential policy to date, from this perspective, and the implications for the policy's best practices.

1. Japanese macro-prudential policy

Heightened interest in macro-prudence clearly reflects the severity of the recent global financial crisis, and the necessity to learn lessons from it. Central banks have been asking themselves whether they paid sufficient attention to the risks being accumulated in the financial system before the crisis, when inflation was moderate and stable. Regulatory authorities have come to regret a possible lack of concern in their policy perspectives, regarding the stability of the financial system as a whole. Now, with deep deliberation, policymakers are focusing on macro-prudential policy to fill the gap between macroeconomic policies and micro prudential policies, so as to avoid any future large-scale financial crisis.

Here I would like to emphasize that, as a central bank, the Bank of Japan has a clear mandate to ensure not only price stability, but also financial system stability. Under this mandate, the Bank has been taking de facto macro-prudential measures since the 1990s.

The Bank of Japan's mandate with regard to the financial system is stipulated in Article 1 of the Bank of Japan Act. Clause 1 of this Article states that the purpose of the Bank is "to issue banknotes and to carry out currency and monetary control". Furthermore, Clause 2 of the same Article states that the Bank's purpose is "to ensure smooth settlement of funds among banks and other financial institutions, thereby contributing to the maintenance of stability of the financial system". Thus, the Bank of Japan Act clearly requires the Bank to contribute to the stability of the financial system as a whole.

To understand what should be done to fulfill this mandate, it is of utmost importance to realize that a distinctive feature of the Asian, and in particular, the Japanese financial system, is that bank lending plays a dominant role in financial intermediation. The non-bank sectors, such as securitization markets, are relatively less important. This is one of the reasons why Asian and Japanese financial sectors were not seriously affected by the financial crisis of 2008, a crisis which was triggered by the gross under-evaluation of the risks embedded in US subprime securitized loans and related structured products. However, the flip side of this coin suggests that the real economy in Japan could be gravely affected if the risk-taking capacity of the banking sector is seriously damaged.

A financial crisis starts with excessive risk taking or an outbreak of euphoria, while its aftermath leaves the economy burdened with excessive risk aversion or a lack of animal spirits. Consequently, the objective of macro-prudential policy is, first, to detect and rectify financial anomalies that may signal excessive risk taking, and second, if a crisis does occur, to support and ensure the risk-taking capacity of the banking sector. Historically, the Bank of Japan has learned a lot from the experience of the burst of the bubble around 1990, and it has used this experience to prevent or at least to lessen the impact of the recent global financial crisis. So, I will begin by explaining the macro-prudential measures employed by the Bank of Japan in the aftermath of Japan's financial crisis since the 1990s, and then I will outline the measures the Bank is implementing now to prevent any future crisis.

After-crisis macro-prudential measures – purchase of stocks held by financial institutions

Since 1990, the Bank of Japan has introduced a number of measures to restore the risk-taking capacity of Japan's banking sector, which had been hampered by problems relating to non-performing loans. Among these measures was the stock purchasing program introduced in the autumn of 2002, which could be interpreted as a proto-typical macro-prudential policy.

The program was introduced when the risk-taking capacity of Japanese banks was severely eroded by non-performing loans. The Bank of Japan purchased stocks held by commercial banks, liberating the capital these banks held against the risks associated with their stock holdings, and thus improving their risk-taking capacity. Seen in this way, the Bank's stock purchasing was akin to the counter-cyclical capital buffers now being discussed in international forums as a possible macro-prudential policy option.

In February 2009, shortly after the global shock wave of seized financial markets, the Bank of Japan reinstituted the stock purchasing program as a temporary measure. Three months later, the Bank adopted another temporary facility to provide subordinated loans to banks. In this way, the Bank took various steps to prop up the risk-taking capacity of the financial system when it was placed under severe stress.

Crisis-preventing measures – on-site examination and off-site monitoring

Now I will illustrate the crisis-prevention measures taken by the Bank of Japan. Above all, I want to emphasize the utmost importance of the Bank's on-site examination and off-site monitoring of individual financial institutions. Financial anomalies or imbalances are likely to be accumulated through undue risk-taking activities by *individual financial institutions*, and crises are usually triggered by their *liquidity problems*.

Since the 1990s, some central banks in advanced economies, such as the Bank of England, have shifted their micro-prudential functions to newly established supervisory agencies. However, having learned the lessons of the latest financial crisis, there has been a tendency to restore the micro-prudential functions back to the central banks again. Unlike these counterparts, the Bank of Japan has been continuously executing on-site examination and off-site monitoring over a wide range of individual financial institutions, including securities firms.

The Bank of Japan's on-site examination makes a thorough and comprehensive assessment of the risks of each financial institution, and strongly encourages the institution to take the necessary action to reduce them, where appropriate. The Bank's off-site monitoring also enables a continuous evaluation of various risks. This off-site monitoring pays particular attention to liquidity risks, and allows the liquidity position of individual institutions to be assessed on a daily basis. These micro-prudential functions by the Bank are critical for identifying and responding to risks, since financial crises usually occur as a result of liquidity crises. Indeed, since the failure of Northern Rock in 2007, the importance of liquidity risk monitoring has been widely stressed in international forums.

Moreover, every fiscal year, the Bank of Japan revises and publishes a document called "On-Site Examination Policy". This document is based on the information obtained from on-site examination and off-site monitoring, as well as on other information concerning economic and financial conditions and the overall state of the financial system. The Bank examines individual financial institutions in line with the policy in this document. For their part, individual financial institutions are expected to take appropriate measures in light of this published examination policy, thus contributing to the stability of the financial system as a whole.

“Two perspectives” of monetary policy

Now let me turn to the relation between monetary policy and macro-prudential policy. Monetary policy does not directly reflect changes in asset prices or in the financial system. Nonetheless, there is a common understanding among advanced economies that variables such as asset prices and bank lending contain important information that should be brought to bear on monetary policy decisions.

Since 2006, the Bank of Japan has adopted a framework for the conduct of monetary policy that consists of “two perspectives”. This means that the Bank may respond to changes in asset prices or credit expansion under the “second perspective”, that is, if there is reason to believe that such changes are “risk factors that significantly impact economic activity and prices”. Through this framework, while price stability remains the primary goal of its monetary policy, the Bank is able to respond flexibly to any excessive accumulation of financial risk. In this regard, the Bank’s monetary policy framework continued to provide appropriate monitoring of financial-sector risks in advance of the outbreak of the current global financial crisis.

2. In search of best practices in macro-prudential policy

As the experience of the Bank of Japan suggests, there are a number of conditions that should be satisfied in order for macro-prudential policy to be effective.

Scope of monitoring – adequate information

First of all, I would like to emphasize the importance of both micro- as well as macro-information in pursuing macro-prudential policy.

In many cases, financial crises are triggered by risk accumulation in individual financial institutions. Moreover, most of the policy tools being discussed in the context of macro-prudential policy, such as changes in the required capital ratio, loan loss provisions ratio or loan-to-value ratio, are intended to be applied to individual institutions. This means that it is all the more important for the central bank to have in hand adequate information from micro-perspectives, in order to pursue macro-prudential policy in an effective manner.

Here liquidity issues should also be duly emphasized. Financial crises usually break out as liquidity crises. Thus, it is absolutely necessary for the central bank to know where in the market liquidity tension exists, and who is under extreme tension, in order to identify and respond effectively to liquidity problems. Quarterly-disclosed balance sheet figures may be grossly insufficient for such crisis management operations. We only have to recall that the capital adequacy ratio of Lehman Brothers was double-digit, even immediately before its collapse. Indeed, the information obtained through the Bank of Japan’s on-site examination and off-site monitoring has proved to be extremely useful, and enabled the Bank to respond swiftly to the liquidity drain in the recent global financial crisis.

Consistency among macro-prudential, micro-prudential and monetary policy

Secondly, consistency with other policies is another important precondition for the efficiency of macro-prudential policy. To put it another way, macro-prudential policy alone is not likely to bring financial stability, without consistent macro-economic policy and micro-prudential policy.

When the asset bubble was at its height, Japan’s regulatory authorities tried to impose a ceiling on the aggregate amount of real estate-related bank loans. Although the term “macro-prudence” was not on everybody’s lips at that time, the restriction imposed on overall real estate-related lending had a strong tinge of macro-prudential policy. Unfortunately, such regulation was not able to stabilize the whole financial system.

A similar instance is also found in the current global financial crisis. In recent discussions on macro-prudential policy, the counter-cyclical provisioning in Spain has often been mentioned as one of the few macro-prudential responses that have actually been implemented. Although such ground-breaking policy efforts by the Spanish authorities are commendable, the current state of the Spanish banking system seems to underline the difficulty of responding to asset price bubbles solely with macro-prudential tools. Since we do not yet have a good track record of averting financial crises solely with macro-prudential policy tools, it would be prudent for policymakers to assume that macro-prudential policy can only succeed when other policies are conducted in a consistent manner so as to influence market expectations effectively.

It seems to me that the precise definition of macro-prudential policies, in isolation from monetary and micro-prudential policies, does not lead to productive discussion. Rather, we should recognize that all these policies partly overlap. Based on this understanding, it is necessary to make use of all available resources, always with a macro-prudential viewpoint, so as to maintain overall financial stability.

Cross-border perspectives – avoid straightjacket measures

Thirdly, I would like to stress the importance of cross-border perspectives on macro-prudential policy.

The business models of financial institutions differ substantially, reflecting the different needs for financial services in each country. Moreover, we should also recognize the significant differences in legal and regulatory frameworks for financial services among jurisdictions, as a consequence of the authorities' best efforts to tailor them to the people's needs. In some jurisdictions a traditional "buy-and-hold" model is dominant, in which banks generally rely on stable household deposits in their funding and make commercial loans. In such cases it is especially important for supervisors to grasp credit risks in banks' loan portfolios. However, in other jurisdictions, where an "originate-to-distribute" model with market-based wholesale funding is more pronounced, supervisors should pay more attention to liquidity structure, the risk-profile of structured products and where the ultimate risk lies.

"Level-playing-field" is undoubtedly important. Nonetheless, what we really need is a playing-field that should lead to fair competition among financial institutions of different types and backgrounds, both in a theoretical and a practical sense. Thus, a global regulatory framework should have sufficient flexibility in order that regulators can take account of regional and functional heterogeneity. A one-size-fits-all regulation, which some institutions in a specific jurisdiction could more easily circumvent, might eventually prove rather harmful to social welfare. Moreover, too rigid regulation might encourage less-transparent entities to replace banks' businesses and thereby stimulate "shadow-banking" in some countries. A one-size-fits-all approach, which would put carnivorous lions and herbivorous elephants in the same cage, can never produce good results. We need to strike the right balance between rules and discretion in financial regulation, making full use of the "Three Pillars" framework of the Basel Accords, especially Pillar II.

I also reiterate that liquidity issues are critical, especially from a cross-border perspective. Central banks are strongly required to monitor liquidity risk, and provide liquidity if necessary, so as to contain cross-border spillovers. In this regard, the Bank of Japan, through its off-site monitoring, observes closely the liquidity position of branches, subsidiaries and affiliates of overseas financial institutions. Moreover, bilateral swap agreements between major central banks, such as the Fed, the ECB and the BOJ, contributed to the containment of cross-border spillovers during the initial stages of the global financial crisis.

Looking back at the history of central banks, most of those established before the Second World War were brought into existence for the purpose of restoring order to a financial system in turmoil. Macro-prudential perspectives are therefore nothing new to central banking. Rather, macro-prudence might be part of the original reason why an economy needs a central bank. Ultimately, it could be argued that all the activities of central banks, from issuing banknotes to operating payment and settlement systems, acting as the lender-of-last-resort and implementing monetary policy, cannot be pursued without a "macro-prudential perspective".

Thank you for your attention.