Jan F Qvigstad: Understanding macroprudential regulation

Introductory remarks by Mr Jan F Qvigstad, Deputy Governor of Norges Bank (Central Bank of Norway), at the workshop on "Understanding macroprudential regulation", organised by Norges Bank, Oslo, 29 November 2012.

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Dear all,

It is a pleasure to welcome you to Norges Bank for this workshop on Understanding Macroprudential Regulation. The topic of the workshop is timely; Authorities in all parts of the world are now actively debating macroprudential policy. Academic research provides a necessary foundation, both for the design and the implementation of such regulations.

During my years of service here at the central bank, and also some years at the Treasury, I have had my fair share of dealings with banking and financial crises in Norway.

In the 1990s, Norway was hit by a severe banking crisis. Three of the four largest banks failed. Required capital injections were more than three and a half per cent of GDP. This is substantially more than the percentage share that euro area banks currently need to recapitalise. Ever since the Norwegian banking crisis in the early 1990s, our banking industry has been regulated more strictly than banks in comparable countries. For instance, bank capital definitions have been tighter, while packaging loans into complex instruments was in practice not permitted until 2007. Financial supervision has also been rather strict.

As a result, the Norwegian financial system only had limited exposure to the subprime mortgage market – notwithstanding some municipalities in the northern part of Norway that got involved, with a less than full understanding of inherent risks. Our banks were therefore relatively unaffected by the recent crisis when it comes to credit risk. The downturn that our economy experienced in 2009 was modest in relation to other countries – but this is of course also due to the composition of our production and exports, with oil accounting for a large share.

More than two decades ago, in the early stages of the Norwegian banking crisis, Norges Bank provided a large liquidity loan to a savings bank. The bank, however, soon became insolvent. We learnt how fast illiquidity can turn into insolvency. At the time, the bank was rescued partly by Norges Bank writing off its loan. This incident showed that it was important to clarify the division of responsibilities between the central bank and the fiscal authorities. The Government Bank Insurance Fund was established, which would be able to extend loans and inject capital into distressed banks in the future. The aim was to make sure Norges Bank avoided intruding into the arena of the fiscal authorities. It is not up to an independent central bank to spend taxpayers' money.

When Norwegian banks' funding dried up in the aftermath of the Lehman Brothers collapse, government bonds were swapped for covered bonds issued by banks. That is, the Ministry of Finance became the banks' counterparty in the swap arrangement. We thereby avoided an expansion of the central bank's balance sheet while improving the liquidity and funding situation of our banks.

The most recent global financial crisis has taught us that it is vital to focus on the financial system as a whole, and not only on its components. Many of the risks that played a role in the recent crisis were identified by central banks and international financial institutions. However, not enough attention was paid to the ways in which these risks were interconnected and how they reinforced each other. System-wide risk amplified the financial crisis and its global repercussions.

An international response to the management of systemic risk has been to introduce macroprudential regulation.

However, incorporating systemic oversight in the financial stability framework poses considerable analytical and operational challenges for most countries. Indeed, we as economists have relatively limited understanding of the design and effectiveness of macroprudential policies. But, even when inflation targeting was introduced, not much was known about how to go about implementing it. Practice and research developed in parallel, interacting. We hope to see similar developments regarding macroprudential policies.

To this end, Norges Bank, like many other national and international monetary authorities, is actively working to further develop the conceptual and analytical foundations for macroprudential policy. Several analytical approaches for the identification of the factors contributing to the building up of systemic risk may be used and different policy tools may be employed to address them. One policy instrument introduced by Basel III is the countercyclical capital buffer.

In line with our past experience of dividing responsibilities, the Ministry of Finance will implement countercyclical capital requirements from 2013. Norges Bank will make recommendations for its buffer decisions. We therefore need to strengthen our understanding of macroprudential regulation and develop relevant analytical tools for our recommendations.

The financial crisis called renewed attention to the fact that developments in the real economy and the financial sector are closely linked. In response, Norges Bank has decided to provide monetary policy and financial analyses in a joint report published quarterly as from 2013. The reports will form the basis for both monetary policy decisions and for our advice on the buffer.

The primary objective of monetary policy is low and stable inflation over time. We operate a flexible inflation targeting regime, which also aims at stabilising economic activity. Furthermore, Norges Bank gives weight to the risk that a prolonged period of low interest rates could lead to elevated risk-taking and excessive debt accumulation in the household and business sectors.

There is always room for improvement. We will seek to improve systemic risk indicators and macro-stress testing approaches, keeping them at the research frontier. We will also work to better incorporate the financial sector in our macroeconomic models.

Economic research can contribute significantly to this, and in this context, some fundamental questions need to be addressed.

– *First, what is the macroeconomic impact of financial regulations?*

A greater understanding of how financial regulations act at the aggregate level is needed, both in containing systemic risk and in affecting the growth potential of economies. This would enable us to make more informed policy recommendations.

– *Second, how should systemic risk for banks, non-bank financial institutions and markets be identified and measured?*

Economists have proposed several methods of measuring systemic risk. But more research is needed in order to understand systemic risk arising from banks and non-bank financial institutions and their interaction.

– *Third, how should monetary policy be conducted in the context of macroprudential policy?*

And there are many more questions, some of which will be discussed during this workshop.

We are eager to learn from the expertise and the experience of other countries. Norges Bank is committed to investing in research and supporting cooperation with other central bankers and foreign academics. This workshop is one product of this commitment.

We are fortunate to have such prominent speakers contributing to the program. I wish you fruitful and stimulating discussions, and I hope you enjoy your stay in Oslo. Fortunately, the weather is on our side, motivating us to stay focused on our work. It would have been more difficult on a sunny day in June.