Tongurai Limpiti: The changing role of central banks in the new financial world

Opening plenary address by Ms Tongurai Limpiti, Deputy Governor of the Bank of Thailand, at the Asian Financial Services Congress 2014 "Defining the Next Decade", Bangkok, 27 February 2014.

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Distinguished Guests,

Fellow Participants,

Ladies and Gentlemen,

Good morning. It is my pleasure and honor to be here. Since its inauguration in Bangkok in 2005, the Asian Financial Services Congress has evolved to become one of the region's largest annual gatherings for the industry, where participants learn the latest industry trends, share ideas and exchange opinions, as well as to network with others. As a returning participant myself, I can assure you the benefits you will get from attending this event and personally also look forward to getting the most out of my two days here.

In this address, I would like to share with you the direction, we central banks, are taking into the next decade regarding the maintenance of financial stability.

In particular, I will talk about the role of central banks in the areas of monetary policy, regulation, and financial sector development. When talking about the last area, I will also update you on the upcoming ASEAN financial integration under the formation of the ASEAN Economic Community or AEC.

Ladies and Gentlemen,

The global financial crisis that erupted in 2008, or 2007 if you count the U.S. sub-prime crisis as its first incidence, has brought fundamental changes to how central banks approach economic and financial stability. In particular, the crisis has led to a general reorientation of central bank policies in three major directions. The first is the reorientation of monetary policy to take into account financial stability concerns. The second is the shift from "deregulation" to "re-regulation". And the third is the supplementation of traditional microprudential regulation with macroprudential one.

In the realm of monetary policy, the pre-crisis consensus was that the attainment of price stability, or low and stable inflation, was enough to ensure a smooth progress of the economy. While central banks were well aware that financial disruptions could have a serious negative impact on the economy, they were of a view that financial stability was the job of prudential regulation and that monetary policy should focus on inflation and output stabilization. The dichotomy between monetary policy and financial stability policy was well observed across the central banking community. Central banks like the Bank of Thailand, which also looks at financial imbalances when making monetary policy decisions, represented only a small minority before the crisis.

The global financial crisis has prompted a fundamental rethinking of central banks' monetary policy conduct. Now it is recognized that price stability alone does not guarantee economic and financial stability and that there exists an intricate relationship between monetary policy stance and financial stability. Maintaining "too low for too long" interest rate policy leads to excessive risk taking that can sink the economy. This risk-taking channel of monetary policy now features prominently in the mainstream economic literature.

Today, virtually all central banks are taking financial stability considerations seriously in their monetary policy deliberation. Talk of risks to financial stability has now been mentioned frequently in several central banks' monetary policy statements. The takeaway from this is that once their economies get back to normal, central banks in developed economies will consciously avoid keeping the policy rate too low for too long. Financial institutions must therefore prepare for a higher interest rate environment as well as volatility during the transition period. The recent emerging markets turmoil provides a fresh example of the latter, even though the current stage of QE tapering is just the tip of an iceberg of what is coming.

Let me move on to re-regulation. The pre-crisis mantra was to let deregulated financial markets take care of themselves. Alan Greenspan, the former Fed Chairman who pushed to have derivatives remain unregulated, expressed that he was in "shocked disbelief" to see what happened. In addition, a number of observers, including Nobel Prize winning economist Joseph Stiglitz, believe that the repeal of the Glass-Steagall Act in 1999, which allowed commercial banks to engage in investment banking activities, was among the major factors behind the crisis.

By re-regulation, I don't mean the return to tight control by regulators, but rather "smarter" regulation that focuses on systemic risks. Let me show my point with some examples.

As a regulator, I would not be doing my job if I did not talk about Basel III. To avoid going overboard on its massive details, I will highlight just a few of its key features.

In a nutshell, there are three parts to Basel III: capital requirement, liquidity risk management, and supervision of global systemically important financial institutions. Of the three, the capital part is in the most advanced stage with national implementation started last year in many countries including Thailand. It is expected that by 2019, most countries will be in full compliance with Basel III capital standards which include a countercyclical capital buffer that varies with credit cycles and a leverage ratio that limits excessive buildups of leverage.

The liquidity part is new and aims to strengthen banks' management of liquidity risk. A stress-test-based liquidity coverage ratio and a longer-term net stable funding ratio will be mandated in 2015 and 2018, respectively.

The final part of Basel III deals with supervision of global banks whose failure could trigger the meltdown of the global financial system. Identified global systemically important banks will be subject to an additional capital surcharge above Basel III capital requirement. This extra loss absorption capacity is to be met with common equity and will be phased-in between 2016 and 2018.

As another example, many of you have probably heard of the recently passed Volcker Rule, named after another former Fed Chairman Paul Volcker. The Volcker rule can be seen as a watered down version of the Glass-Steagall Act. Recognizing that it is difficult to separate investment banks and commercial banks entirely, the Volcker Rule prohibits commercial banks from short-term proprietary trading of securities, derivatives, futures, and options on these instruments. The goal is that eliminating these risky practices will make banks safer and at the same time force them to refocus on core banking businesses which in turn should benefit consumers.

Basel III and the Volcker Rule are just two examples of re-regulation. There are several others, notably the U.S. Dodd-Frank Act, the OTC derivatives markets reform, and the proposed oversight and regulation of shadow banking. Taken all together, these make a comprehensive set of regulatory reforms that will busy both regulators and financial institutions over the next several years.

I would like to stress however that, for financial institutions, the compliance with the new regulations is not a one-way process, but a two-way one that you can help shape through industry consultation and collaboration with regulators. The challenges for country regulators are whether and when to adopt certain parts of international standards that may be irrelevant, too stringent, or lead to new risks for the domestic industry. By working together, we can ensure not only the smooth adoption of international standards, but also that our financial system will not be burdened by unnecessary rules and unintended consequences.

The third direction is the emerging role of macroprudential regulation. The global financial crisis has shown that traditional or microprudential regulation which focuses on the safety and soundness of individual financial institutions fell short of crisis prevention. While financial institutions may be individually safe, collectively they may be at risk due to herd behaviors and their interconnections. There is thus the need to look after the safety and soundness of the financial system in the aggregate, which is why the word "macro" in macroprudential.

In essence, macroprudential regulation reduces systemic risks by building up resilience of the financial system during periods of credit boom and rising leverage as well as limiting spillovers from interconnections of financial institutions. It is indeed easy to see that several aspects of Basel III are macroprudential in spirit such as the countercyclical capital buffer and the requirement of large global banks to hold more capital.

It is noteworthy that even before the global financial crisis, central banks in the Asia Pacific have routinely used macroprudential tools such as the loan-to-value or LTV ratio and minimum income requirement for credit card borrowers. We just did not call them macroprudential. In some way, it took the West their own crisis to realize the importance of restraining the buildup of systemic risks early on.

Ladies and Gentlemen,

The final part of my talk concerns the developmental role of central banks. When it comes to financial stability, this is an often overlooked and underappreciated role. Looking back at history however, one finds a number of financial crises were associated with flawed or ill-timed financial liberalization. Thus the path set forward for the financial sector by central banks may lead to destruction as well as prosperity.

The Thai financial crisis in 1997 was a case in point. Although it was an inconsistent macroeconomic policy mix that precipitated the crisis, it was the decision back in the 1970s to allow structurally risky finance companies to operate alongside with commercial banks and the creation of the Bangkok International Banking Facilities in the hope to transform Bangkok into Asia fourth financial center after Tokyo, Hong Kong and Singapore that made the financial sector vulnerable with overloaded risks. Thus, when we started anew with our Financial Sector Master Plan to guide future developments of the Thai financial sector in 2004, the two structural weaknesses were the first two to be eliminated.

Fast forward to today, all eyes are now on ASEAN financial integration under the AEC Blueprint to create a semi-integrated financial market by 2020. The ASEAN financial integration framework comprises four areas, namely financial services, payments and settlements systems, capital account, and capital markets. It is noted that the target date is beyond 2015 for the AEC. This is because financial markets are much harder to integrate than goods markets given different structures and policies among membership and the sector's sensitive nature.

Of the four areas, the first three are under central banks. Let me however touch on only the first two which I deem are most relevant to this audience.

The first area, financial services liberalization will be done primarily through the creation of Qualified ASEAN Banks or QABs, indigenous ASEAN banks that are allowed to operate in all ASEAN countries under the dimensions of equal access, equal treatment, and equal environment. Currently, involved regulators are focusing QAB discussions on the qualification of such banks as well as regulatory and supervisory issues to ensure the soundness of financial institutions. Bilateral negotiations for QABs may commence this year for countries which are ready.

For payments and settlements systems, the AEC vision is to have "integrated, safe, and efficient" systems that will "enable businesses and individuals to make or receive electronic payments with greater convenience."

To achieve this vision, five key sub-areas are targeted: cross-border trade settlement, money remittances, retail payment system, capital market settlement, and standardization. Examples of specific goals in these areas are achievement of T+1 receipt of funds for cross-border payment, full regional ATM interoperability, and an adoption of ISO 20022 as a common standard for payment and settlement messages.

Ladies and Gentlemen,

Given the limited time, it is impossible to get into fine details. Nevertheless, I hope that I have given you a big picture of the changing role of central banks post global financial crisis. This encompasses the reorientation of monetary policy and regulatory frameworks and to a lesser extent central banks' financial-sector development role.

As I outline what lies ahead in the policy environment, some of you may worry about the increasing interest rate environment and higher regulatory costs, outweighing your excitement for the AEC. But let me assure you that these are healthy developments for the long run. With lower crisis risk, risk premia will be lower. And the most efficient and well-run financial institutions will be the ones who reap the most benefits from this new environment.

Thank you for your attention.