Erwin Riyanto: Unveiling macroprudential policy

Speech by Mr Erwin Riyanto, Deputy Governor of Bank Indonesia, at the 10th International Conference on Bulletin of Monetary Economics and Banking and book launch, Jakarta, 8 August 2016.

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Honorable,

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Distinguished Guests, Ladies and Gentlemen

Assalamu'alaikum Wr. Wb,

Introduction – greeting & objectives

1. It is a great honor for me to be here in this 10th International Conference and Book Launch event. Please allow me to divert your attention to review the next book entitled "mengupas kebijakan makroprudensial" or "unveiling macroprudential policy". This book I believe is not just any other book. It is the first book ever published about macroprudential policy in Indonesia. It is one that is meant to educate the public with a better understanding of what is macroprudential policy, why is it important, what are the policy instruments, how it interacts with other policies and who should better have the mandate.

2. Since work in the macroprudential field has only gained momentum globally following the 2008 crisis, much of the concepts are still evolving. In this book, we will come across many new financial terminologies that in principle have already been around for some time but have not yet explored. To name a few of the new terminologies are systemic risk, contagion, interconnectedness, shocks, vulnerabilities, idiosyncratic vs cross-sectional risk dimensions and macroprudential. While macroprudential policy and the aforementioned terminologies are more understood by those directly involved in the field, there is a growing need to familiarize the notion to the public-at-large.

3. Why? because evidently, implementation of macroprudential policy directly touches upon financial agents and more than often requires inter-agency support for its effectiveness. With proper knowledge and understanding of the macroprudential framework including the transmission of systemic risk, the public can gauge their contribution to preserve financial stability. In this case, limiting the tendency for risk exuberance behavior. Furthermore, the recent enactment of the Law on Financial System Crisis Prevention and Resolution not only compels the public to be equipped with a stronger understanding of systemic risk but also with regards to the importance of institutional arrangement and crisis management protocol.

4. The Law on Financial System Crisis Prevention and Resolution provides a legal standing for the institutional arrangements between BI, OJK, Ministry of Finance and the Deposit Insurance as part of The Financial System Stability Committee.

The Act stipulates the roles of each institution in deliberating coordination to safeguard financial system stability, mitigate financial system crisis and handling of systemic bank problems; during normal and financial system crisis conditions. The Act was constructed on the basic principle of alienating the use of tax-payers money. This is achieved with reference to Basel III principles that focus heavily on mitigating systemic risk and strengthening banks' resilience, particularly the ability of systemic banks to bail itself.

The basic concept of macroprudential policy and systemic risk

5. The next question is then what is systemic risk? What is macroprudential policy? Macroprudential policy has been well defined in the IMF, BIS and FSB's documents, as well as published papers. There are at least 3 (three) key elements to describe macroprudential policy. First, it aims to safeguard financial system stability. Second, the focus is on system-wide perspectives instead of individual financial institution's safety and soundness level. Third and most central element is that it aims to limit the build-up of systemic risk.

6. Systemic risk itself is known as the risk of widespread disruption to the provision of financial services, which can cause serious negative consequences for the real economy. Systemic risk can be recognized through vulnerabilities related to the build-up of risks over time or from interconnectedness and the distribution of risks within a financial system at any given point in time. By mitigating systemic risk, macroprudential measures ultimately aim to reduce the frequency and severity of financial crises.

7. How can this be achieved? Lessons from the 2008 crisis taught us that microprudential policy alone tends to overlook the build-up of risk taking behavior of financial institutions. Furthermore, long periods of low interest rates and a single monetary objective geared towards low inflation may also give rise to the build-up of systemic risk when uncoupled with sufficient prudential measures. Therefore, macroprudential policy aims to maintain a balance between macroeconomic and microeconomic objectives through implementation of prudential principles in the financial system. The notion is to limit risk-taking behavior of financial agents.

The history of macroprudential policy in Indonesia

8. While much attention and work on addressing systemic risk through macroprudential policies became viral after the financial global crisis, a number of countries in the emerging market have used macroprudential tools well before. Bank Indonesia has implicitly paid due consideration and acknowledgement to the importance of macroprudential aspects in terms of maintaining financial system stability since early 2000. Such acknowledgment gave rise to the establishment of the Financial System Stability Bureau in 2003.

9. The assessment on financial system stability has also been deliberated through the publication of the Financial Stability Review every semester since 2003. Inevitably, our early experience in managing financial stability following the Asian financial crisis in 1999 managed to salvage the Indonesian economy from adverse impact of the 2008 turmoil.

Why the central bank has an important role in macroprudential policy?

10. Now, one might question, who should be most suited to receive the mandate for macroprudential policy? Observably, there are considerable differences in the institutional arrangements across countries as there is no "one size fits all". However, in most jurisdictions, regardless of the type of institutional setup, the central bank is given an important role, including veto powers in a committee setup.

11. The pivotal role of the central bank is mainly supported by the uniqueness of the central banks function as lender of last resort and as an independent authority. The ability of the central bank to create liquidity in the banking system is a unique advantage in preserving financial stability. The central bank as monetary authority also has considerable information advantage concerning the complex interactions of the financial intermediary system and the operation of the real economy. Such advantage would allow the central bank to gauge potential systemic risk, for example through calibrating the impact of macro-stress scenarios to the resilience of financial intermediaries. Furthermore, the primary objective of the central bank to achieve price stability, also goes hand in hand with financial stability; that is, they mutually reinforce each other in most cases. Another unique function of the central bank is in the payment systems. The central bank has the information and expertise to identify potential risks and deadlocks in the payment system, which may cause serious disruptions to the financial system.

Macroprudential policy mandate & the MP framework in Bank Indonesia

12. Based on a joint progress report of the FSB, IMF and BIS to the G20, effectiveness of macroprudential policy is served by providing the relevant authority with a clear mandate. In this case, Bank Indonesia has the mandate to perform the role of a systemic regulator and to exercise macroprudential supervision as stipulated in the Act No.21 of 2011 concerning the Financial Services Authority. Given the role of Bank Indonesia as the systemic regulator, we continue to strengthen our expertise in monitoring systemic risk through developments in our macroprudential policy framework. The framework must provide clear, transparent and accountable objectives with a focus on maintaining financial system stability.

13. The macroprudential policy framework maintains financial system stability through four objectives that are: (i) early identification and mitigation of systemic risk, (ii) minimization of financial imbalances to improve the quality and soundness of intermediary functions, (iii) efficient financial systems and (iv) improving access to finance by expanding SMEs access and financial inclusion. In an emerging economy, improving access to finance is a continuous effort integral to financial market development; either through financial broadening or financial deepening. It also aids in mitigating systemic risk that may arise from a financial system that is still concentrated in a particular corporate sector and certain segments of society.

14. In order to operationalize these macroprudential objectives, there are 4 main elements to focus on that are: (i) identification of the sources of systemic risk; (ii) macroprudential surveillance through monitoring and analyzing identified risks; (iii) formulation of policy responses through implementation of macroprudential tools; and (iv) crisis management protocol.

Sources of systemic risk: shocks and vulnerabilities

15. The process of identifying sources of systemic risk involves identifying shocks and vulnerabilities. Materialization of systemic risk is triggered by an interaction between shocks and vulnerabilities. In this case, a shock may come through changes in macro-economic conditions. Meanwhile, vulnerabilities are associated with pre-existing fragilities of the financial system which will amplify and propagate the initial shocks to the financial system. Examples of vulnerabilities include high levels of leverage, maturity transformation, interconnectedness, and complexity. Bank Indonesia is currently developing the Balanced Approach Method to

identify the key source of potential systemic risks that will be considered as top priority to monitor and address.

16. It is important to highlight that while shocks are inevitable, identifying and addressing vulnerabilities becomes the key to ensuring robustness of the financial system. In addition, a number of early warning indicators and methodologies can be useful to assess vulnerabilities well before the emergence of stress. In this case, Bank Indonesia has employed many indicators and developed several models to detect the vulnerabilities in the financial system as well as the build-up of systemic risk. We have also developed models to assess the systemic impact and the resilience of the financial system to systemic risk, such as the Indonesian Financial Cycle as imbalances indicator, Financial System Stability Index as stress indicators, macro stress test and also top-down bank stress test models.

17. Given that vulnerabilities and systemic risks may arise from different sectors as well as changes in market behavior and in macro-economic conditions, Bank Indonesia must have access to a wide-range of information sources. This includes the authority to conduct off-site and on-site examination if needed. It is worth highlighting that there is a considerable difference in the main objective of Bank Indonesia's examination to the OJK. That is to identify the potential systemic risk as an impact of macroeconomic condition to the bank's resiliency, and its potential contagion impact to the industry. Furthermore, on-site examination will have an objective to ensure compliance of Bank Indonesia regulation covering monetary, payment system and macroprudential.

Macroprudential policy instruments

18. Furthermore, following the identification of possible systemic risks, macroprudential policy instruments are tailored to address such risks in both time and cross section dimensions. Macroprudential instruments in the time dimension, aim at increasing resilience to shocks and contain pro-cyclical build-up of systemic risk. The instruments often used include (i) capital based tools (ii) asset side tools or loan restrictions and (iii) liquidity related tools. In a cross section dimension, macroprudential tools aim to reduce contagion risks by improving resilience of systemic institutions for example, via additional capital surcharge and loss absorbency requirements. Other prudential tools in the cross section dimension include increasing risk weights and large exposure limits.

19. Overtime, Bank Indonesia has implemented a broad range of macroprudential instruments including capital-related tools as required by Basel III such as Counter Cyclical Capital Buffer as well as asset-side tools and liquidity-related tools. Asset-side tools include certain loan restrictions, such as LTV caps and to boost credit have put in place incentives and disincentives in the form of reserve requirements linked to loan to funding ratios. To strengthen corporates resilience to exchange rate shocks, Bank Indonesia also introduced requirements for hedging ratio and forex liquidity ratio.

Macroprudential policy interaction with others policies

20. In the areas where macroprudential policy interacts with microprudential policy, Bank Indonesia and OJK work hand in hand in formulating the optimum policies. For instance, Bank Indonesia has contributed work and research to the formulation of LCR requirements with OJK and in the identification of systemically important bank as mandated by the Law on Financial System Crisis Prevention and Resolution. Bank Indonesia and OJK have also established a bilateral coordination framework to facilitate and to optimize cooperation and coordination in carrying out the function, duties, and authorities of Bank Indonesia and OJK.

21. Recognising the potential interaction of macroprudential policy with other policies that also have a bearing on systemic risk, requires strengthening of inter-agency coordination. Such interaction between macroprudential policy not only applies with microprudential policy but also with monetary and fiscal policies. As mentioned by the IMF in their recent stock taking paper,

boundaries and interactions between policies are complex and can give raise to both complementarities and tensions that may need to be resolved. For example, via suitable institutional arrangements which we effectively already have in place.

Closing remarks

22. To conclude, it is my greatest hope that this book can serve as a gateway for the public to better understand macroprudential terms and concepts as well as its main objective in mitigating systemic risk. With better understanding of the systemic risk transmission, we as individuals can help contribute in preserving financial system stability by limiting exuberance risk taking behaviour. Hopefully, despite our inability to read the crystal ball of the next crisis, we would presumably have better ammunition to deal with the headwinds and financial turbulences that are yet to come.

Thank you.