Conference on
Reserve Requirements & Other Macroprudential Policies:
Experiences in Emerging Economies

Country Experience with the use of Macroprudential Policies – Malaysia

Istanbul, Turkey
9 October 2012

Nor Shamsiah Mohd Yunus
Deputy Governor
Bank Negara Malaysia

Use of macroprudential instruments (MPIs) is not new to Malaysia

- **MPIs have been used to address pro-cyclicality and systemic risk build-up:**
  - Risks generated by strong credit growth and credit-driven asset price inflation
  - Risks arising from rising leverage and risk-taking
  - Risks related to large and volatile capital flows

- **Typically used as a *complement* to other measures, in particular, *supervisory actions* which is the preferred measure to stem risk build-up**

- **Hence, past usage of MPIs was targeted at:**
  - Enhancing financial institutions' resilience against business cyclical variations
    - Accumulation of buffers
    - Enhancing risk management capabilities
  - Address build-up of imbalances (e.g. asset price bubbles)
    - Managing destabilising capital flows, credit growth and risk-taking activities
  - Stimulating economic activities during downturn

MPI design principles and considerations in Malaysia

- **Key elements**
  - **Discretionary**
    - Pre-emptive implementation
    - Timely upliftment
  - **Targeted**
    - Reduce spillovers
    - Avoid excessive complexity
  - **Allow calibration**
    - Adjust parameters as conditions change
  - **Coordinated with other policies**
    - Complement monetary, fiscal & micro-prudential policies

Supported by strong institutional arrangements and governance framework to manage complex policy trade-offs

Example: Malaysia's experience in deployment of MPIs in 1990s

Large capital inflows created upside pressures on prices of financial assets and real estate

Measures to discourage large scale inflows of short-term funds (e.g. limits on non-trade external liabilities of banks; prohibition of forwards (bid side) and non-trade swaps with non-residents; restrictions on sales of short-term monetary instruments to non-residents; limits on purchase of properties >RM250k by non-residents

Sectoral lending limits

MPI
- Loans secured by shares & unit trusts (1991)
- Loans to the broad property sector (1997)

Aim
- Limit banks' exposures to the equity market/broad property sector and reduce speculative and investment activities

Loan-to-value (LTV) limits

MPI
- Max. financing margin of 75% for purchase of passenger cars (1991)
- 60% LTV for: (1995)

  Residential properties (not for own-dwelling and >RM150k)

  Shops (not for own business and >RM300k)

Aim
- Curb excessive lending for consumption purposes
- Contain systemic impact of correction in domestic property market and curb speculative activities

Selected exchange controls to reduce internationalisation of the ringgit

Key lessons learnt in ensuring effective deployment of MPIs

- **Timely implementation and upliftment of MPIs to prevent unintended consequences and avoid "overshooting"**
  - ***Not an exact science*** → requires sound analyses, collective judgment and willingness to act
  - Able to anticipate and manage potential circumvention, inadvertent spillovers or shift of risks to other sectors/segments
  - Some MPIs can be retained or modified ***over time*** to manage risks ***in more vulnerable or "contagious" segments***
    - E.g. sectoral lending limits to the broad property sector and equity and unit trust markets were retained over time to preserve prudent exposures

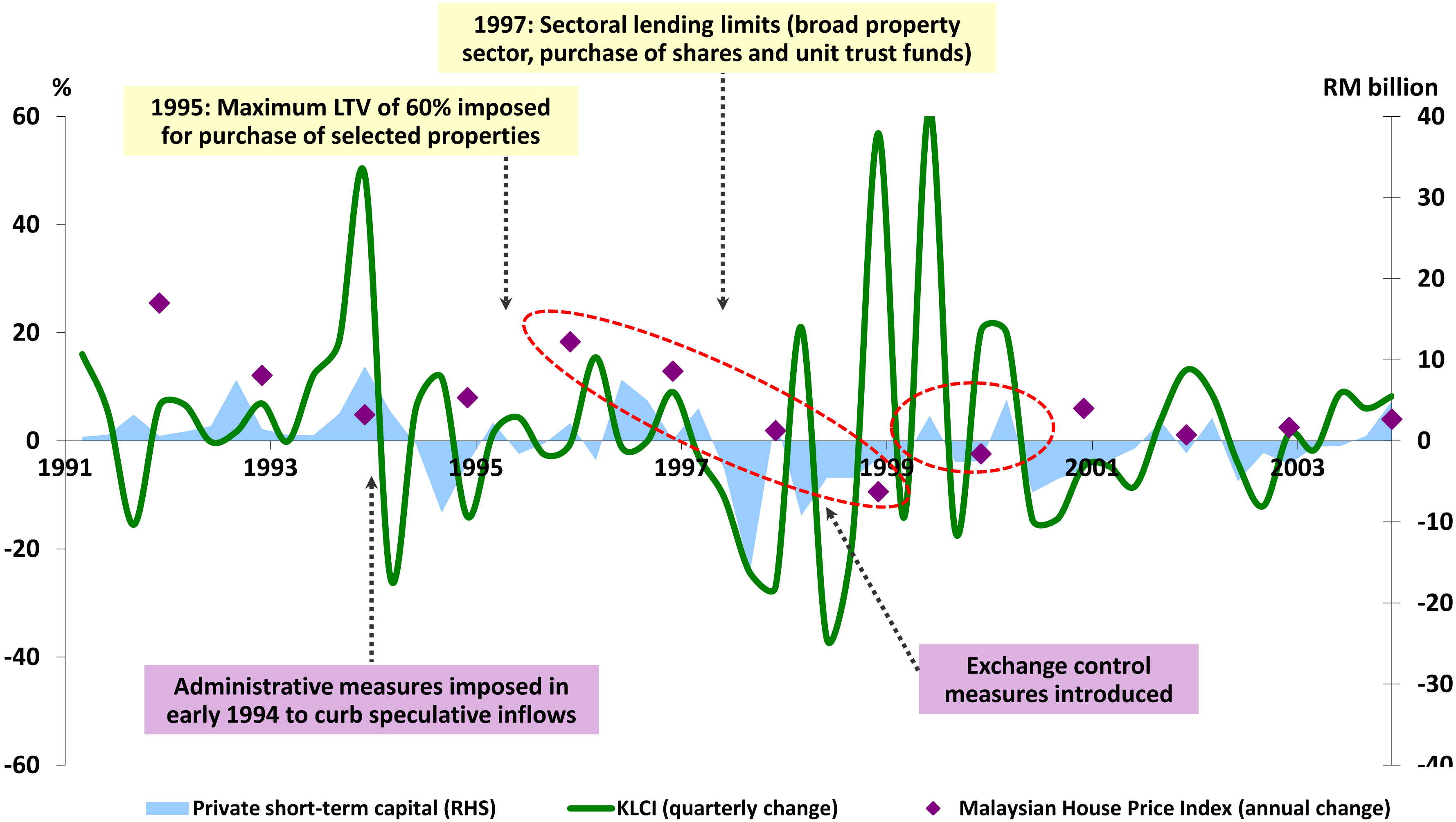
- **Progressive and targeted implementation**
  - Difficult to reverse the impact of unintended effects
  - Continuous monitoring, analyses and recalibration to respond to changing conditions

Key lessons learnt in ensuring effective deployment of MPIs (*cont'*)

- **Difficult to gauge effectiveness and precisely attribute intended outcomes to specific MPIs**
  - Introduced as part of a broader package of pre-emptive countercyclical measures which worked in concert
  - Economic/financial cycles led to inherent changes in credit growth, risk appetite or leverage
  - ***Hence, each new deployment requires careful analyses*** – past successes do not guarantee similar experiences over time (1990s ***vs*** 2010s experience)

- **Nevertheless, based on Malaysia's experiences, we believe that a more disruptive correction or significant systemic impact would have followed if certain MPIs were not instituted in the past**
  - Property prices stabilised shortly after LTV limits in 1997 (lowest ↑ since 1993)
  - Moderation in margin financing mitigated impact of sharp equity ↓ during the Asian financial crisis

Example: Impact of MPIs deployed in 1990s



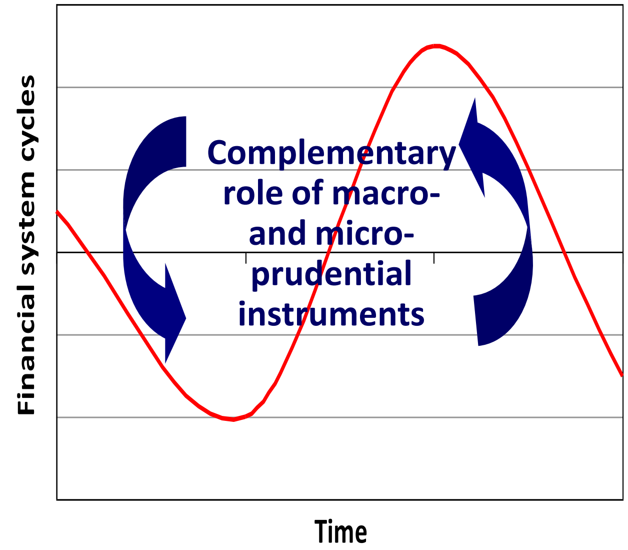
Staged implementation to address specific issues and avoid adjustment in financial markets

In Malaysia, both macro- and micro-prudential tools play mutually reinforcing roles in addressing pro-cyclicality

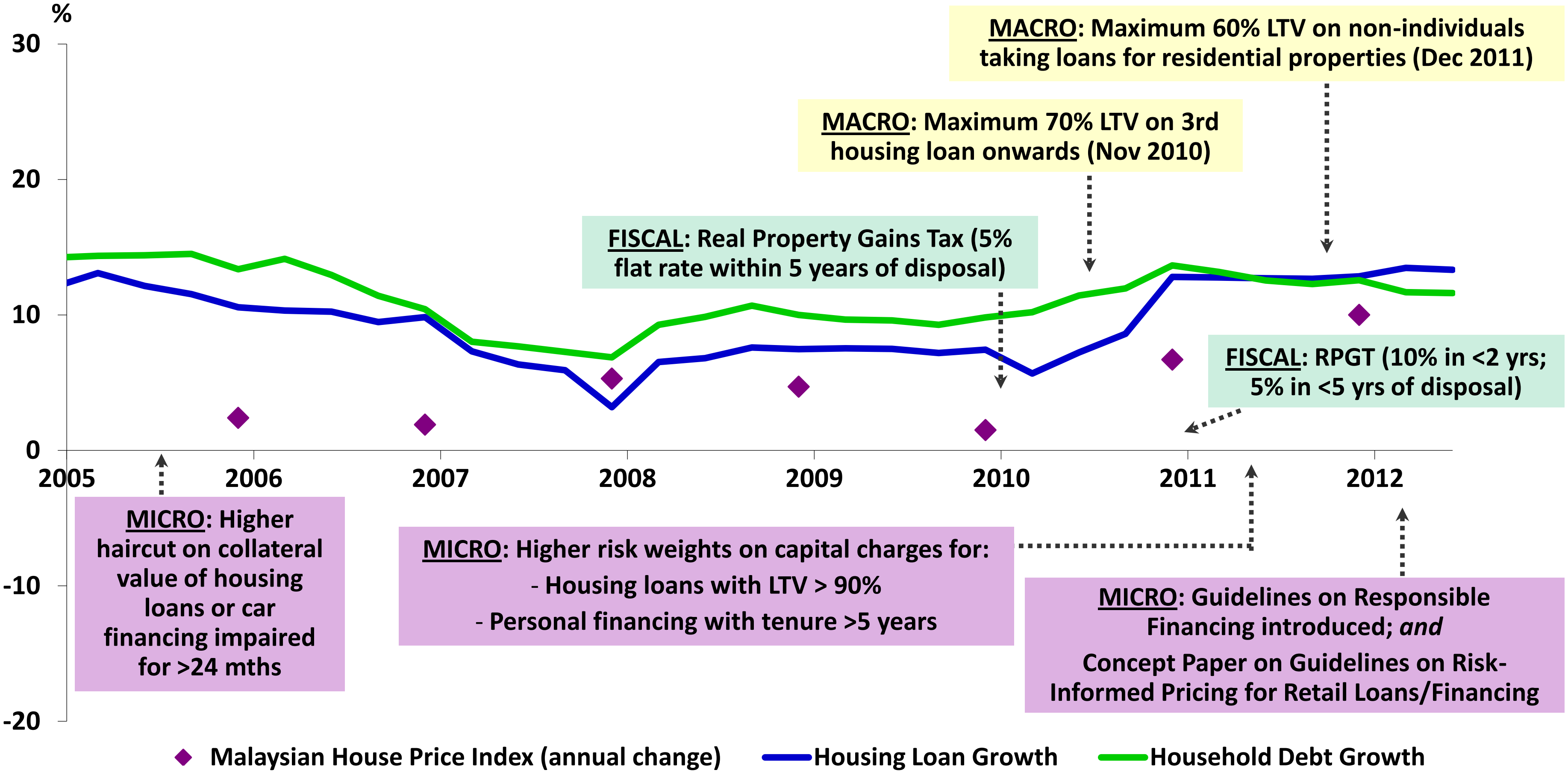
- **MPIs broaden the perspective and application of conventional micro-prudential tools**
  - MPIs are reconfiguration/overlays to micro-prudential instrument settings
    - "Collective ***vs*** institutional" safety and soundness
    - Calibration according to degree of or contribution to systemic risks
  - Useful to reduce pro-cyclical nature of financial behaviours
    - Restrain excessive risk-taking (due to 'short-termism)
    - Promote build-up of buffers in good times

E.g. of counter-cyclical supervisory tools by the Bank

- **Approval for dividend payments and new products**
  - Encourage capital conservation and reduce incentives to take excessive risks in good times
- **Dynamic provisioning**
  - Minimise risk of underprovisioning, particularly during good times, and promote profit-smoothing strategies
- **Adjustments to risk weights**
  - Deter risk accumulation/concentration in riskier segments
- **Forward-looking (through-the-cycle) valuations or inputs to risk pricing/models**



Example: Combination of macro- and micro-prudential responses deployed in 2010s



Targeted implementation to moderate excessive speculation in property market and promote sustainable household

Initiatives to ensure Malaysia's macroprudential policy framework remains dynamic, relevant and effective over time

1 Infrastructure development and capability enhancement

- Dedicated division accountable for financial stability mandate
  - BNM's Financial Stability Sector reorganised by functional lines with clear accountabilities
  - Separation between consumer protection and market conduct with supervisory functions
  - Greater integration between macro- and micro-prudential assessments and policies
- Ability to synthesise and integrate information/assessments from various sources
  - Macroeconomic conditions, market behaviours and intelligence
  - Balance sheet imbalances and systemic risk concentration
  - Supervisory assessments; Trends in payment, settlement & money remittances
  - Macro and micro stress testing
- Enhanced information sharing and surveillance mechanisms among domestic and regional supervisory authorities

Initiatives to ensure Malaysia's macroprudential policy framework remains dynamic, relevant and effective over time (*cont'*)

2 **Continuous review of sources and channels of risk transmission due to rapid evolution of the financial sector**

- Externally-driven ***vs*** domestic vulnerabilities
- Regulated ***vs*** non-regulated entities/sectors
  - E.g. Non-regulated entities increasingly interconnected with FIs and play more prominent role in financial intermediation
- Cross-border risk transmissions and contagion channels

- **Entails continuous monitoring and review of surveillance and regulatory perimeter**

2

The Central Bank of Malaysia Act 2009 provides clear and pre-emptive triggers for exercise of financial stability powers on regulated and non-regulated entities

In the opinion of the Bank

Risk to financial stability

Disrupts or is likely to disrupt

Financial intermediation process

Disrupts or is likely to disrupt

Orderly functioning of the money and FX markets

Affects or is likely to affect

Public confidence in the financial system

Stability of the financial system

2 Comprehensive powers to address systemic risk & vulnerable FIs

- Within and outside of Bank's regulatory perimeter

Central Bank of Malaysia Act 2009

Ex-ante surveillance powers for timely risk identification

- Access to information either directly or indirectly via relevant authorities

Power to enter into arrangements, advice and make recommendations to other supervisory authorities

- Co-operate and coordinate financial stability measures
- Promote laws & policies that are consistent with financial stability

Pre-emptive powers to avert or mitigate systemic risks

- Order to undertake corrective measures for the purpose of financial stability
- Liquidity assistance
- Capital support

Ex-post powers to minimise impact of instability

- Order for compulsory transfers (part or whole of business, shares, assets and liabilities)
- Bridge institution

2 Practical challenges to extend the perimeter of systemic risk monitoring and deployment of MPIs

- **Identifying and understanding shadow banking entities or activities that may pose systemic risks and regulatory arbitrage concerns**
  - Information gaps
  - Design of key triggers and thresholds

- **Designing and implementing regulations for shadow banking**
  - Managing trade-off and possible shift of activities to informal/illegal sector
  - Managing moral hazard – expectations of public sector interventions

- **Supervisory toolkits and legislative powers to deal with risks posed by shadow banking system**

- **Institutional arrangements and mechanisms to facilitate effective inter-agency coordination**

Initiatives to ensure Malaysia's macroprudential policy framework remains dynamic, relevant and effective over time (*cont'*)

3 **Putting in place institutional and governance arrangements for effective deliberation and consideration of macroprudential measures to safeguard financial and macroeconomic stability**

- E.g. Joint Policy Committee
  - Chaired by the Governor, and comprises members of the Financial Stability Committee (FSC) and Monetary Policy Committee
  - Deliberation of and deciding on macroprudential policies that have broader implications on economy
    - In instances where supervisory responses are sufficient, and/or macroprudential response being considered is not likely to have a wider implication on the macroeconomy, the FSC shall be the decision making authority
  - Manage interactions and policy trade-offs between mutually reinforcing mandates

3 Enhanced institutional and governance arrangements

Recommendations with systemic implications

Financial Stability Executive Committee

- High level committee established under s.37 of CBA 2009 to review and decide on the Bank's recommendations to manage risks to financial stability
  - Entities outside regulatory perimeter of the Bank
  - Involves public funds
- Chaired by the Governor of BNM

Joint Policy Committee for effective deliberation and consideration of macroprudential measures to safeguard financial and macroeconomic stability

Financial Stability Committee
(within the Bank)

- Risk assessment
- Macroprudential responses
- Microprudential responses
- Supervisory interventions
- Monitor implementation of approved actions by Executive Committee
- Trigger resolution of member financial institutions by the Malaysia Deposit Insurance Corporation

Monetary Policy Committee
(within the Bank)

- Maintaining price stability while giving due regard to the developments in the economy
- Formulation of monetary policy and policies for the conduct of monetary policy operations

Initiatives to ensure Malaysia's macroprudential policy framework remains dynamic, relevant and effective over time (*cont'*)

4 **Adopting effective communication strategies**

- Promote greater understanding of macroprudential issues, analyses and policies
- Where appropriate, induce adjustments in behaviours of players and market participants

- **Core features of effective communication of policies and issues**
  - **Correctly timed** → avoid over-reaction and manage expectations
  - **Clarity** → markets, investors and public typically fear the worst in absence of clear information
  - **Consistent *(across time and different stakeholders)*** → strengthen credibility
  - **Concise** → 'more' is not always effective; allow for some 'constructive ambiguity'
  - **Coordinated** → strong inter-agency mechanism to minimise uncertainties/mixed signals
  - **Credible** → reducing misinformation helps shape and influence expectations
  - **Continuous** → engagement with stakeholders to gauge effectiveness

Key challenges in the medium term

- **Malaysia has sufficient legal powers to develop and deploy various MPIs, but challenge remains in managing the potential trade-offs and spillovers**

- **Adopting more "rule-based" MPIs e.g. counter-cyclical capital buffer (CCCB)**
  - In Malaysia, we plan to include CCCB in our macroprudential policy toolkit – however, challenges remain in development of "rule-based" trigger
    - Need to consider domestic economic and financial structures, and availability of historical data for calibration

- **Effective communication of the use of MPIs to support confidence and steer the financial system towards a sustainable path**
  - Avoid over-reaction or "self-fulfilling prophecy"

- **Cross-border coordination and engagement among regulators, supervisors and central banks given increased regional presence by domestic banks**

Thank you

Q & A