



The **SEACEN** Centre

The South East Asian Central Banks (SEACEN)
Research and Training Centre

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on Financial Stability

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Editorial Board

The Board of Governors of The South East Asian Central Banks (SEACEN) Research and Training Centre has appointed the following experts on financial stability and related matters to the Editorial Board of the *Journal*:

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Mr. Nestor A. Espenilla, Jr.
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Bangko Sentral ng Pilipinas

Mr. Michael J. Zamorski
Adviser, Financial Stability and Supervision
The SEACEN Centre

The Editorial Board has designated Mr. Zamorski as Chief Editor.

THE SEACEN CENTRE

SEACEN's core membership is comprised of nineteen central banks/monetary authorities in the Asia-Pacific region. SEACEN serves its members through its learning programs, research work, and networking and collaboration platforms for capacity building in central banking knowledge. Through its various activities, SEACEN also strives to promote financial stability in the region, especially through maintaining cooperative relationships and the advocacy of good and best practices in financial institution supervision and central bank policy actions. In addition to its 19 members, it has an outreach of 16 other central banks in the Asia-Pacific region, as well as 26 regional and international strategic partners with whom SEACEN collaborates in the design and delivery of its learning programs.

Article Submission Guidelines

The *SEACEN Financial Stability Journal* Editorial Board welcomes potential contributions to the *Journal*. Articles written for the *SEACEN Financial Stability Journal* should focus on providing insights and thought leadership with respect to information and developments relevant and critical to promoting financial stability and related matters, contextualized to the Asia-Pacific region.

- Article drafts should be submitted in 12 point Times Roman font and should be double-spaced, and sent by email to: article@seacen.org.
- The length of draft articles will generally range from 3,000 to 5,000 words (12 to 20 double-spaced typed pages), though treatment of some topics could necessitate longer articles, which would be considered.
- Authors should include a short, three or four sentences, biographical summary about themselves at the end of the article. If an article expresses expert opinions, contributors' expert credentials should be apparent.
- The Chief Editor and Senior Manager, Communications Unit, are available at any time to answer authors' questions, discuss potential articles, review early drafts, or provide other input.
- Articles will be evaluated by the *Journal's* Editorial Board.

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Letter from the Executive Director

Dear Colleagues and Readers,

Throughout its long and distinguished history, The South East Asian Central Banks (SEACEN) Research and Training Centre has been dedicated to meeting the needs of its member central banks and monetary authorities in a proactive and practical way. It is therefore my privilege, on the occasion of the celebration of SEACEN's 30th Anniversary, to introduce the first issue of a new professional publication -- the ***SEACEN Financial Stability Journal***. This important new strategic initiative is intended to advance thought leadership and collaboration on financial stability matters among our members, contextualized to the Asia-Pacific region. We also hope to influence international policy debates on promoting financial stability.

There are numerous high-quality research journals devoted to economics and monetary policy. Very few publications focus on practical implementation issues related to promoting financial stability and systemic risk management from a central bank/monetary authority perspective.

The ***Journal's*** Terms of Reference, as approved by the SEACEN Board of Governors, state:

"The Journal provides an accessible forum for central bankers/monetary authorities, financial institutions regulators and policymakers to proactively discuss technical issues and policy measures for financial stability in the Asia-Pacific region. A particular focus will be on promoting sound bank supervisory standards, macroprudential policies, and bank risk management and governance practices that support regional financial stability."

The three articles selected for inclusion in the Journal's first edition by the Journal's Editorial Board reflect the broad range of issues that relate to financial stability. We are honored that Her Excellency Dr. Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, has contributed a thought-provoking article on the governance of financial stability given the context of the current rethinking in financial stability frameworks. An article from Bangko Sentral ng Pilipinas discusses safety and soundness considerations related to microfinance. Additionally, an article by SEACEN staff highlights key findings of IMF/World Bank Financial Sector Assessment Program country reports published in 2012 and 2013, and their relevance for countries' ongoing financial stability self-assessments.

I would like to take this opportunity to express our gratitude and thanks to the Editorial Board members and SEACEN member central banks for their input and contributions to the *Journal*. I also wish to thank our governing bodies, namely the SEACEN Board of Governors and SEACEN Executive Committee, for their strong support and endorsement of the *Journal*. Lastly, I hope that the *Journal* will provide our readers with valuable insights and practical, actionable information on crucial issues pertaining to financial stability.

Hookyu Rhu
Executive Director
20 October 2013

The Central Bank Financial Stability Mandate and Governance Challenges¹

By Dr. Zeti Akhtar Aziz

1. Introduction

Central banks have an integral role in financial stability. Historically, this was derived from the central bank's functions in issuing currency and preserving its value within a monetary system, its central position within inter-bank clearing and settlement systems, and its role as the lender-of-last-resort. Many central banks were also given formal responsibility for the regulation and supervision of banks – reflecting concerns over moral hazard associated with the public safety net and the central bank's key involvement in resolving bank failures – and for the oversight of large-value payment systems.

During and in the period following the global financial crisis of 2007-08, the demands intensified for central banks to restore and safeguard financial stability, notably through actions directed at containing systemic risks. In many cases, central banks, including those without bank supervisory functions, were compelled to act despite ill-defined responsibilities and lacking the necessary powers and tools to do so.² It is noteworthy that prior to the crisis, a number of central banks were being devolved of their bank supervisory functions in favour of separate supervisory authorities,³ and central bank frameworks for delivering price stability had developed to an advanced state of sophistication that was not seen in the area of financial stability. While these developments appeared to suggest trends towards a more limited, even declining role of central banks in financial stability, the global financial crisis leaves little doubt as to the fundamental role of central banks in financial stability, whether explicit or implied.

A re-thinking of financial stability frameworks has ensued on the need to strengthen institutional arrangements for financial stability, independently of the question of whether the functions of banking supervision should be combined with, or separated from, the central bank. Several themes have emerged. There is broad consensus on the need to improve the policy settings for the mitigation of systemic risk. In addition, authorities should have the ability to use a combination of micro- and macroprudential tools to address the build-up of financial imbalances (or excesses) given the potential implications for financial stability. While prudential levers should continue to be the primary instruments used to respond to financial stability risks, monetary policy responses should not be excluded when necessary.⁴ Existing approaches to the supervision of individual financial institutions should also be complemented with considerations of the management of systemic risk and with greater emphasis on having in place credible recovery and resolution plans designed to preserve the core economic functions during periods of stress. Finally, given the possibility⁵ of reliance on taxpayer funding to finance bank failure resolutions, effective mechanisms should exist for authorities to be held accountable to the electorate.

This paper focuses on the governance of financial stability from a central bank's perspective given the above context of evolving financial stability frameworks. A starting point for examining this issue is the identification of the key challenges that arise for central banks in the pursuit of financial stability. This provides a backdrop for the following sections which discuss the different aspects of the governance of financial stability – focusing in particular on the mandate, powers, accountability structures and relationships involved in the management of financial stability by central banks. The role of coordination in a domestic and cross-border context, and the related issues that arise, including in managing crises, will be discussed. In the remaining sections, the issue of central bank independence in the context of financial stability will be specifically examined. The article concludes with observations on the new demands being placed on the institutional capability of central banks.

2. Challenges for Central Banks in the Pursuit of Financial Stability

Central banks are confronted with a number of challenges in the pursuit of financial stability. To begin with, there is no widely accepted, universal definition or measure of financial stability. It is more often described in its negative form – for example, the absence of conditions in financial markets or institutions that harm or threaten to harm economic performance⁶ – and usually with little precision. This renders the design of an appropriate operational framework for delivering financial stability much more difficult in comparison with that which exists for monetary stability. Financial crises are also inherently difficult to predict owing to the multi-faceted contagion paths and the complex relationships that exist between components of the financial system and the real economy. This is compounded by the diversity of the financial system which includes the financial intermediaries, the organised formal and informal markets, the payment and settlement arrangements and financial market infrastructures. The actions of individual agents within each of these components of the financial system can have significant implications for financial stability. Yet in many countries, authorities which have responsibility for the different components are dispersed, each with different mandates. The result is an inevitable, sometimes confusing or even inconsistent, mix of multiple goals, instruments and agencies involved in the task of promoting and safeguarding financial stability. These conditions, though not ideal, tend to work themselves out without too many problems in normal times. But during times of crises, they present significant difficulties and can impede critical and timely actions, and undermine accountability.

A second challenge concerns transparency. While acknowledging that transparency has an important role in promoting financial stability by enabling the relevant parties to make accurate assessments of financial conditions and providing the necessary environment for effective market discipline, there are limits to the degree of transparency that can be achieved on any evolving threats to financial stability. By virtue of their role in the financial system and their position in financial markets, central banks are often the first to receive early signals of emerging risks to financial stability. There are, however, real constraints in releasing such information when

there is a high risk that it would precipitate a confidence crisis resulting in extreme volatility in the financial markets or bank runs that ultimately have self-fulfilling effects. At the extreme, a financial crisis may erupt which could have otherwise been avoided. Concerns with ensuring the effectiveness of policies to respond to financial stability threats may also dictate that advance consultation and full transparency are sometimes undesirable when they are likely to undermine the intended effects of the policy by inducing an escalation of speculative activities in asset markets, or otherwise significantly increase moral hazard.

Often cited in the literature is also the concern that the prominent role of central banks in financial stability would increase the scope and potential for policy conflicts. The inherent conflicts between monetary policy and financial stability are well documented. While there is greater recognition of the legitimate role of monetary policy in preserving financial stability, concerns have been raised on the potential for reputational damage to and the erosion of the independence of central banks in the conduct of monetary policy. Another long standing issue, recently revived in the debate concerning the Single Supervisory Mechanism proposed for Europe, is that a central bank with responsibility for supervision (whether macro- or microprudential supervision) would run the risk of becoming a supervisor with access to central bank liquidity (Coeure, 2013).⁷

The dual objectives of monetary and financial stability may also have political implications – notably political involvement in establishing the goals to be achieved under these objectives and the determination of priorities when there are trade-offs. Political sensitivities can be further heightened by the nature of central bank actions to address risks to financial stability. Unlike monetary policy, these actions draw on a much broader range of powers and instruments which central banks can wield, including the provision of emergency liquidity assistance, prudential regulation and supervision, powers to resolve systemically important financial institutions that are in difficulty and acting as market maker of last resort. In a full-blown crisis, decisions may be taken to provide large financial institutions with capital support in order to protect the wider economy from a free fall, with implications on taxpayers' monies.⁸ Such actions may have distributional consequences and political ramifications that cannot be ignored. Even in the realm of monetary policy, the recent use of unconventional tools amounting to quasi-fiscal actions has seen central bank actions tread towards the more politically sensitive space.

Finally, the extraordinary interventions by central banks to prevent a collapse of the financial system during the global financial crisis has re-ignited concerns – previously raised in connection with decisions to place the supervisory functions under the central bank – over the excessive concentration of powers in the central bank. However justified by a recognition of the strong expertise and alignment of incentives that make central banks well-placed to manage financial stability, granting wide powers and discretion to an unelected institution continues to be contentious. This can be observed in tensions between according central banks an expanded role in preserving financial stability, and moves to simultaneously curtail

absolute discretion by central banks through demands for more clearly defined and increasingly complex decision-making structures. The Dodd-Frank Act illustrates this tension – giving the Federal Reserve an explicit mandate for financial stability and extending its oversight powers over systemically important financial institutions, while pulling back the emergency authority for some forms of lending by the Federal Reserve.⁹

3. The Nature of the Financial Stability Mandate of Central Banks

Central banks need to be given a clear mandate for financial stability that corresponds with their critical role in responding to financial crises. The Bank for International Settlements (BIS) observed that an important reason for this is “*to reduce the risk of a mismatch between what the public expects and what the central bank can deliver.*”¹⁰ In reality, central banks are almost always expected by the public to take a lead role in managing a financial crisis. At the height of a financial crisis, the immediate public concern is with restoring stability. The public expects the authorities to use whatever means available at their disposal to achieve this, and the legislature has usually granted such emergency powers (typically to central banks) when required for this purpose. This would suggest that gaps between public expectations and the limits of central banks’ authority can be closed when needed, but the process may not always be smooth or expedient. A clear financial stability mandate for central banks is also important to provide a framework for accountability which should recognize that the central bank has multiple objectives, with priorities that may differ under different conditions and which involves trade-offs that need to be managed.

Two trends can be observed in the period following the global financial crisis. The first is the move to expand the policy mandates of central banks to include financial stability as an explicit goal. The second is the substantial strengthening of that mandate – mainly through additional powers granted to the central bank – to reflect a financial system that is far more complex and with a higher propensity for systemic non-bank entities to also be a potential cause of major financial disruptions.

Table 1 compares the financial stability-related mandates of central banks in a selected sample of countries before and after 2009.¹¹ Prior to 2009, a number of central banks did not have a significant role in the oversight of the financial system as a whole. In almost all of these cases, the table shows that the responsibility of central banks for the oversight of the financial system as a whole has since been, or is in the process of being, firmly established either in law or under enhanced institutional arrangements. Meanwhile, central banks that have always had a significant role in the oversight of the financial system have generally also seen this role being further reinforced. Another significant change has been the review of institutional structures in the United Kingdom and parts of Europe to combine the supervision functions under the central bank, reflecting the more dominant structures that have prevailed in Asia.

Table 1: Comparative Changes in Central Bank Mandates Post 2009

	Central bank mandates before 2009	Key changes since 2009
France	• Major responsibility for oversight of the financial system as a whole • Some legal grounding for financial stability responsibilities • Primary role in the supervision of banks; lesser role in regulation	• Establishment of a super-regulator, the Prudential Supervisory Authority (PSA) within the Banque de France • Banque de France, incorporating the PSA, given explicit financial stability mandate
Indonesia	• Some responsibility for oversight of the financial system as a whole • Some legal grounding for financial stability responsibilities • Primary role in the regulation and supervision of banks	• Establishment of Otoritas Jasa Keuangan (OJK), and integrated supervisory agency for the financial services sector in Indonesia • Regulation and supervision of banks will be transferred from Bank Indonesia (BI) to OJK by the end of 2013, although OJK is obligated under law to coordinate with BI in formulating banking regulation
Korea	• Minor responsibility for oversight of the financial system as a whole • Some legal grounding for financial stability responsibilities • Some role in the supervision of banks (mainly the ability to participate in examinations of banks by the Financial Supervisory Service (FSS), or to request that such examinations be conducted by FSS)	• Bank of Korea (BOK) given a statutory duty to pay attention to financial stability in carrying out its monetary and credit policies • Strengthened statutory obligation for FSS to comply with a request on the conduct of bank examinations by BOK • Wider ability of BOK to provide emergency credit (liquidity support facilities) to financial institutions and for-profit (commercial) enterprises
Malaysia	• Major responsibility for oversight of the financial system as a whole • Some legal grounding for financial stability responsibilities • Primary role in the regulation and supervision of banks and insurers	• Bank Negara Malaysia (BNM) given statutory objective for financial stability • Extended powers granted to the BNM to regulate, supervise and resolve systemically important non-bank financial institutions
Philippines	• Minor responsibility for oversight of the financial system as a whole • Some legal grounding for financial stability responsibilities	• Amendments to the central bank law underway to formalise and extend the financial stability functions of Bangko Sentral ng Pilipinas (BSP)

	• Primary role in the regulation and supervision of banks	• Other proposed amendments to provide BSP with the expanded avenues and tools for financial stability (including the extension of the lender-of-last-resort facility to systemically critical non-bank institutions)
US	• Major responsibility for oversight of the financial system as a whole • Financial stability responsibilities are only weakly grounded in law • Primary role in regulation and shared responsibility for supervision of banks	• More prominent formal role of the Federal Reserve in financial stability recognised in law • Expanded role to regulate and supervise systemically important non-bank entities
UK	• Major responsibility for oversight of the financial system as a whole • Financial stability responsibilities are grounded in law • Minor role in the regulation and supervision of banks	• Bank of England given statutory objective for financial stability • Macro- and microprudential supervision of financial institutions (banks, insurers and other prudentially significant firms) integrated under the central bank
EU (European Central Bank, ECB)	• Some responsibility for oversight of the financial system as a whole • Financial stability responsibilities are grounded in law • Minor role in the regulation and supervision of banks	• Creation of three new independent supranational European Supervisory Authorities.¹² ECB is a non-voting member of the banking authority • Creation of the European Systemic Risk Board (with significant representation of central banks) tasked with detecting risks to the financial system as a whole

4. Defining Financial Stability Goals

To achieve clarity in the central bank's mandate for financial stability, the question as to what precisely central banks will be held accountable for must also be addressed. This can be described in the form of specific goals or objectives of financial stability that central banks with financial stability mandates must achieve. Goal-setting theory teaches us that goals should be specific, measurable and time-bound. The difficulty with financial stability is that it is a broad, multi-dimensional concept and therefore, inherently challenging to quantify in a single, consolidated measure. One can be reasonably specific as to the individual components of financial stability, for example, orderly market conditions or sound financial institutions, but achieving a set of goals for the individual components in isolation does not by itself deliver financial stability on a sustainable basis. It has been noted that "*financial stability is expectation-based,*

dynamic, and dependent on many parts of the system working reasonably well" (Schinasi, 2004). Important to add to this is that the components of the financial system must work reasonably well in a way that the failure of one component would not trigger the contagious failure in the other components. This demands that any goals set for individual components of financial stability must also consider the relationships with goals set for other components, and would need to take into account how the goals (individually and collectively) relate to changing economic and financial conditions. Because financial stability is also concerned with tail events, time-bound goals are also inappropriate.

Given the political dimensions of financial stability actions and their potential for conflicts with other policy objectives of central banks, it is extremely important for central banks to know with great clarity the outcomes to be achieved, which in turn will define the limits of actions that central banks can take in order to promote and preserve financial stability. Having clarity in the financial stability goals to be achieved would enable central banks to evaluate policy options and provide an important discipline against an over-extension of the central bank's powers.

Central banks also need to know the information and develop the surveillance frameworks that are required for the effective identification of threats to financial stability. Such information can be vast in its volume and scope, increasing the risk of "missing the forest for the trees." Clarity in the financial stability goals tasked to central banks will allow the central bank to remain focused on systemic risks and threats to financial stability (particularly if it also conducts microprudential supervision), and holds the central bank responsible to ensure that the information is regularly updated and the surveillance frameworks enhanced as market, structural and economic conditions change.

A further reason concerns the powers needed for central banks to effectively deliver financial stability. Once there is clarity in the central bank's responsibility for financial stability, it needs to have the full range of powers necessary to discharge this responsibility. The need for and existence of the powers should not be confused with the oversight of decisions with respect to their use. The central bank must have the necessary powers, but the decisions to use these powers may be subjected to higher standards of accountability, for example, through mechanisms that provide for the independent review of decisions either ex-ante or ex-post.

Several central banks have sought, through public pronouncements, to aid the general understanding of what financial stability means within the context of their own jurisdictions. Some examples from the Asia-Pacific region are provided in Table 2. It can be observed from the table that not all central banks with explicit financial stability mandates in law offer a working definition of financial stability. Conversely, some central banks that are not given such an explicit mandate have gone to some length in public statements to explain what financial stability means. Malaysia in 2009, and the UK in 2011, have adopted formal definitions of financial stability in law for the purpose of clarifying the central bank's mandate for financial stability.

Table 2: Financial Stability Mandates of Selected Central Banks

	Explicit statutory mandate for financial stability	Public statements* to explain financial stability
Reserve Bank of Australia	No	A stable financial system is one in which financial intermediaries, markets and infrastructures facilitate the smooth flow of funds between savers and investors and by doing so, help promote growth in economic activity. Conversely, financial instability is a material disruption to this intermediation process with potentially damaging consequences for the real economy.
People's Bank of China	Yes	-
Hong Kong Monetary Authority	Yes (specifically, stability of the banking system)	-
Bank Indonesia	No	Sources of financial system instability are identified through a forward-looking process to ascertain the potential risks that could influence the future condition of the financial system. Once identified, these risks are analysed for their potential heightened threat, contagion effect and systemic impact that could devastate the economy.
Bank of Japan	Yes	Financial system stability refers to a state in which the financial system functions properly, and participants, such as firms and individuals, have confidence in the system.
Bank of Korea	Yes	Financial stability can be defined as a condition in which the financial system is not unstable. It can also mean a condition in which the three components of the financial system – financial institutions, financial markets and financial infrastructure – are stable.
Reserve Bank of New Zealand	Yes (statutory obligation to publish financial stability reports)	-

Bangko Sentral ng Pilipinas	No	Financial stability refers to the financial system's efficiency to redistribute and manage risks in a satisfactory manner and carry out payments settlement while remaining responsive to the demands and challenges faced by the economy.
Monetary Authority of Singapore	Yes	Confidence and stability are fundamental to a well-functioning financial system. Only when there is confidence in the system would corporates and individuals transact in the financial markets to invest and to raise capital. Without confidence and stability, the economy's ability to mobilise savings for economic use will be compromised.
Bank of Thailand	Yes	-

* From central bank websites

Other examples from a literature review show attempts to describe conditions that are generally present when there is financial stability. These include:

- *“the ability of the financial system to consistently supply the credit intermediation and payment services that are needed in the real economy if it is to continue on its growth path”* (Rosengren, 2011);
- *“a financial system...[that is] capable of facilitating the performance of an economy, and of dissipating financial imbalances”* (Schinasi, 2004);
- *“a condition where the financial system is able to withstand shocks without giving way to cumulative processes, which impair the allocation of savings to investment opportunities and the processing of payments in the economy”* (Padoa-Schioppa, 2003).

From an accountability perspective, a key problem with most existing definitions of financial stability is that they provide substantial scope for central banks to believe that they are delivering financial stability right up to the point when a financial crisis breaks. This is not useful when there is also an expectation of central banks to take preventive actions to avert a crisis, aside from remedial actions to contain its costs if and when a crisis occurs.

A useful definition of financial stability should serve to meet the outcomes intended by providing clear goals for the central bank to achieve – that is knowing the outcomes to be achieved, knowing the information and monitoring frameworks required, and knowing the powers that are needed for achieving the mandate. References

to “*the dissipation of financial imbalances*,” “*the ability to withstand shocks*,” “*contagion effects*,” and “*material disruptions to the intermediation process*” add important nuances to the financial stability definition that help to clarify the goals that a central bank will be held accountable for.

In Malaysia, financial stability is defined in the Central Bank of Malaysia Act 2009 in reference to risks: (i) that disrupt, or are likely to disrupt, the financial intermediation process and functioning of the money and foreign exchange markets; or (ii) that affect, or are likely to affect public confidence in the financial system. The law mandates Bank Negara Malaysia to act as necessary to avert these risks. This approach takes into account the principal financial stability concerns, while allowing a broad set of indicators and triggers to be developed and judgment to be applied by the Bank within the clearly scoped guiding parameters in law. It also provides a clear link between the financial stability powers accorded to the Bank, and the purpose for which those powers are intended to be used. Importantly, it strengthens the accountability of the Bank through an obligation imposed on the Bank to demonstrate either that a risk to financial stability as defined exists, or there are realistic prospects that the risk will arise. This supports the preventive dimension of responses to financial stability threats by ensuring that the Bank can act pre-emptively. Through a clear demonstration of the risks to financial stability, the Bank can be judged on whether actions taken were appropriate and effective in averting or reducing those risks. It also allows the Bank to exit in a timely manner from any exigent measures taken when it can be shown that the identified risks no longer pose a threat to financial stability.

5. Powers for Financial Stability

The effectiveness of central banks in delivering the financial stability mandate is fundamentally dependent on the range of powers and policy instruments accorded to them. As noted by the BIS¹³, “*charging the central bank with responsibility for financial stability is not sufficient – appropriate tools, authorities and safeguards are also needed.*” During the global financial crisis, the urgency to restore confidence in the financial system and to unlock gridlocks in funding flows for intermediation activities saw the powers of central banks that were at the epicentre of the crisis stretched to the limit, resulting in some cases in emergency or additional powers granted to the central banks to prevent the collapse of their financial systems. This included, somewhat controversially, the provision of emergency lending against a wider range of, and riskier collateral. In other parts of the world, central banks have also gained additional and wide-ranging powers. These expanded powers reflected the specific lessons drawn from the global financial crisis, but also more generally, the broader mandates and responsibilities given to central banks in respect of financial stability as well as the significantly more complex sources and triggers of instability.

Apart from the provision of emergency liquidity which has conventionally been a central bank function to arrest financial panic, the expansion of central bank powers for financial stability has been mainly concerned with crisis prevention and containment.

An important – and often understated – power of central banks in the prevention of crises is its ability to obtain information, including from parts of the financial system that are not traditionally regulated, for the purpose of identifying and monitoring potential risks to financial stability. More often, this ability is present when central banks also have supervisory functions, but this is limited to the entities that they supervise. This remains the case in many countries, including those within the membership of SEACEN. The ability of central banks to obtain information that facilitates its assessment of risks to financial stability should, however, exist independently of any powers of supervision. Central banks in many jurisdictions also generally have the ability to make recommendations to other authorities that also contribute to financial stability on measures to address identified financial stability risks. Increasingly, this ability is being recognised more formally either in law, or under the terms of reference of inter-agency cooperation arrangements.

Any recommendation made by the central bank to another authority has, however, tended to be of an advisory nature, reflecting the political realities that can arise with multiple financial regulators having the potential to affect financial stability outcomes through their actions. This leaves the ultimate decision to take a measure in the hands of the authority concerned, raising some practical challenges in the implementation of the measures needed, particularly where the authority concerned is constrained by the limits of its own powers or tools to undertake the measures. It can also create tensions when mandates of the central bank and other authorities are not aligned. These difficulties have been acknowledged by the G20 which, in an effort to achieve greater alignment, has advocated that *“as a supplement to their core mandate, the mandates of all national financial regulators, central banks and oversight authorities, and of all international financial bodies and standard setters (IASB, BCBS, IAIS and IOSCO¹⁴) should take account of financial stability.”*¹⁵

Some countries have gone further to provide absolute or reserve powers to the central bank to take actions directly in circumstances where threats of financial instability are imminent and actions by the relevant primary authorities have been inadequate to avert such threats. The Financial Policy Committee (FPC) of the Bank of England has the *“power to direct the microprudential authorities.”*¹⁶ This takes into account the fact that *“directions could also be valuable when action is required urgently.”* Similarly, Bank Negara Malaysia has powers, subject to the approval of the Financial Stability Executive Committee (FSEC),¹⁷ to issue orders for financial stability to institutions supervised by another authority, provided that the authority shall be represented as a member at the FSEC meeting that decides on the relevant orders.

Another important preventive power is the ability to vary prudential requirements or ratios applied to financial intermediaries to produce countercyclical effects. This includes the use of countercyclical buffers during periods of rapid credit expansion or asset price inflation. Such macroprudential tools are gaining greater prominence as an important part of the central bank's expanded toolkit. Central banks are considered well-placed to apply such powers given their important role in monitoring and understanding macroeconomic conditions and the close interlinkages between the

financial sector and the broader economy. These perspectives allow central banks to identify and assess the potential for wider destabilising ramifications of such systemic developments.

With increased connectivity within the financial system, and between the financial system as a whole and the domestic economy as well as with other financial systems abroad, a horizontal dimension of supervision that is focused on preserving the effective and orderly functioning of financial intermediation and financial markets has become an important imperative. This has prompted recent moves to draw a clearer distinction between the objectives of supervision of systemic financial institutions (or macroprudential supervision) vis-à-vis other financial institutions (microprudential supervision). Macroprudential supervision is concerned with interlinkages and concentration of risks in the financial system which can arise through the presence of an important financial institution (or a group of financial institutions) or financial market infrastructure whose failure can result in the rapid transmission of risks to other parts of the system.

Distinctions between macroprudential supervision and microprudential supervision can be observed in three respects. The first is the imposition of higher prudential standards – notably in the form of capital surcharges and requirements on recovery and resolution plans – on systemically important financial institutions. Another has been the higher intensity of supervision applied to systemically important financial institutions. For some central banks that are not responsible for micro level supervision and regulation of the financial industry, such as the Bank of Korea and the Oesterreichische Nationalbank,¹⁸ new powers have been gained for the central bank to undertake macroprudential supervision, including the conduct of examinations on major and systemic banks. Among central banks that are also responsible for bank supervision, the Federal Reserve and Bank Negara Malaysia have also been accorded with expanded powers to supervise systemic financial institutions and systemic financial infrastructures which may not already be under their direct supervisory oversight.

The distinction between macroprudential and microprudential instruments is, however, not always clear. This reflects the diverse nature and characteristics of financial stability in contrast to monetary policy where the mandate is better understood and the choice of policy instruments more straightforward. It can be argued that most macroprudential instruments are extensions of powers that are already available to microprudential supervisors. In introducing the Basel III countercyclical buffers,¹⁹ the BIS emphasised that the measure was *primarily* aimed at protecting the overall banking system from periods of excessive credit expansion and risk build up, thus ensuring the availability of capital to withstand periods of stress following such an expansionary phase.²⁰ This places the use of such buffers well within the remit of the microprudential authority. It is also often true that macroprudential policies are rarely implemented in isolation, and follow a period of heightened supervisory intensity which is typically sustained throughout the period that macroprudential policies are in effect. These observations have raised questions over how effective, really, are macroprudential instruments, in particular when they are used without other accompanying measures.

For instance, to address the build-up of financial imbalances in the property market, the central bank may impose a loan-to-value (LTV) ratio requirement. At the same time, the banking prudential supervisor may increase scrutiny over the underwriting and risk pricing practices of banks, potentially requiring all banks (not just more risky ones) to strengthen their buffers and adopt more stringent standards (For example, lowering loan-to-value ratios). Meanwhile, the market conduct authority may intensify the focus on banks' conduct in soliciting new business while the fiscal authority may impose tax requirements. It would be extremely difficult in these circumstances to attribute any positive effects of these interventions to any single measure, least of all a measure that is distinctly "macroprudential."

The use of macroprudential measures is also often fraught with measurement challenges. In the classic example of LTV ratios which act as "speed bumps" to slow down the pace of growth in mortgage lending, there is no precise or scientific way of setting the ratio levels. Debate also continues on the relevant macroeconomic indicators on which to base the application of countercyclical buffers. It is also acknowledged that market participants and economic agents are likely to eventually adjust to any calibration of macroprudential measures, which means that any effects of these measures may be temporary at best.

Despite the measurement challenges and current debate on the effectiveness of macroprudential instruments, many central banks particularly in Asia have effectively deployed these instruments to address periods of imbalances notably during the 1980s and 1990s, and also more recently. While some appear to have had greater success than others, for countries that continued to experience pressures on asset markets despite the deployment of macroprudential measures, it can be argued that the magnitude of these pressures and the associated vulnerabilities created could have been substantially higher had those measures not been introduced. A better understanding of the effects of macroprudential instruments and how they interact with other powers at the disposal of central banks and other financial stability authorities would contribute towards the more optimal use of macroprudential instruments – including their adjustment over time in response to changing conditions.

With respect to crisis resolution and containment, central banks typically are accorded stabilisation powers that aim to restore confidence or liquidity in the market, thus enabling financial intermediation to resume. At the core of these powers is the ability of central banks to provide emergency liquidity. In addition, the ability "*to alter the composition of central bank assets, by adding to (subtracting from) its holdings of claims on the private sector*" (Goodhart, 2011) represents an additional means by which central banks have acted to meet demand for market liquidity. These more unconventional forms of liquidity support have been contentious given that it creates significant exposures for central banks to major financial and balance sheet risks. In times of stress, this may, in turn, affect the capacity of the central banks to perform their mandated roles in other equally important areas, monetary policy being a key one. Ways in which central banks have strove to manage these risks include lending only against acceptable collateral or securing a financial back-stop from the government.

Some central banks have additionally acquired new powers to undertake resolutions of financial intermediaries and systemic financial market infrastructures. There are compelling reasons for placing responsibility for the resolution of financial institutions under a separate resolution authority and not central banks.²¹ An important reason is to insulate central banks from political influence and intervention given the potential fiscal implications of resolution actions. Having the resolution responsibility under a separate authority would support a clear focus and strategies on the development and maintenance of specialised skills and capacity required to effectively implement resolution strategies. There are also benefits in separating the resources and focus of attention required to manage a crisis from that required to undertake specific resolutions, although close coordination between the two would be both inevitable and critical.

6. Decision-Making Arrangements for Financial Stability

Decisions on the use of financial stability powers involve the choice of policy instrument, the management of policy trade-offs, as well as the timing and extent (or calibration) of the measures to be taken. Internationally, varying practices can be observed in the decision-making structures and the supporting processes adopted for the exercise of financial stability powers that have been accorded to the central bank. Not unlike the trends observed in the area of monetary policy, committee-based decision-making structures have become more common, reflecting the multifaceted dimensions of financial stability issues that increase the need to draw on broad-based expertise and perspectives to support sound judgments and decisions.²² Such committees provide an avenue for rigorous debate and critical challenge which arguably contribute to better decisions. This can be important when financial stability decisions can involve complex choices that entail balancing trade-offs. Multiple and potentially conflicting objectives of the central bank, the sensitivity of decisions to market conditions, and the uncertainties inherent in key variables in the decision process are additional reasons that favour committee-based decision-making structures.

Committees for financial stability are generally constituted of members internal to the central bank, with some committees having provisions for external members. Members of internal financial stability committees of central banks tend to be drawn from senior central bank officials involved in regulation, supervision, the oversight of payment systems and treasury/investment operations (due to the potential need for emergency liquidity). Apart from the Governor and Deputy Governor(s), central banks have generally observed some separation between members of the monetary policy and financial stability committees. This is intended to reduce potential conflicts that can arise when concerns over the viability of individual institutions may influence monetary policy outcomes. While this remains a legitimate concern, it is also important to recognise that financial stability responses, both of a micro- and macroprudential nature, are important in addressing financial imbalances. Excessive credit growth and unsustainable levels of household indebtedness are among such imbalances that represent a risk to both monetary and financial stability. Given these interactions, structures that allow for cross-functional deliberations to take place across the financial

stability and monetary policy functions of the central bank can be useful. In 2010, Bank Negara Malaysia established the Joint Policy Committee comprising members of the Financial Stability Committee and Monetary Policy Committee to address the common concerns of both the financial stability and monetary policy goals.

Table 3: SEACEN Central Banks with Internal Committees for Financial Stability

	Name	Focus	Composition
Bank Negara Malaysia	Financial Stability Committee (since 2004)	• Macroprudential assessment and responses • Microsurveillance intervention and resolution • Crisis management	Chair: Governor Members: • All Deputy Governors • Assistant Governors responsible for regulation, supervision, treasury & investment operations and payment systems
Bangko Sentral ng Pilipinas	Financial Stability Committee (since 2010)	• Policy direction for financial stability with emphasis on mitigating the build-up of systemic risk	Chair: Governor Members: • All Deputy Governors • 3 other senior officials
Monetary Authority of Singapore	Financial Stability Committee	• Supports Board level Chairman's Meeting, a designated forum for major policy decisions relating to the objective of financial stability, in addition to its oversight of major changes to microprudential policies	Chair: Managing Director Members: • Senior management overseeing surveillance, supervisory and prudential policy, markets and investments, and economic policy functions

The Financial Policy Committee of the Bank of England is one example of a committee with provisions for external members. Four of the FPC's 10 members are individuals appointed from outside the central bank based on their relevant expertise. Within Asia, such committees with external members more commonly serve to promote effective inter-agency coordination. Consistent with this objective, the members of most of these committees tend to comprise of officials serving in an ex-officio capacity from relevant agencies that have some role in financial stability. The supranational European Supervisory Authorities serves a similar purpose. In Malaysia and Thailand, external members on financial stability committees include individuals other than those in an ex-officio capacity to further enhance the decision-making process. The FSEC in Malaysia is specifically mandated in the law to approve certain financial stability actions by the Bank and its membership includes external members who are

appointed on the basis of their professional expertise and experience. The Financial Institutions Policy Committee in Thailand similarly makes decisions on policy matters and includes external members with financial industry and market experience. A challenge noted in both countries with the inclusion of external members on financial stability committees has been the difficulty of identifying suitably qualified members who are not also conflicted by their business associations. While it may be expected that the decision-making arrangements can differ during normal and crisis times, there is little evidence of this in practice among central banks that adopt committee-based decision-making structures.

Table 4: SEACEN Economies with Committees for Financial Stability that include External Members

	Name	Focus	Composition
India	Financial Stability and Development Council	• Systemic oversight, regulatory coordination, financial sector development, literacy and inclusion	Chair: Minister of Finance Members: • Governor, Reserve Bank of India • Securities and Exchange Board of India • Pension Fund Regulatory and Development Authority • Insurance Regulatory and Development Authority
Indonesia	Financial System Stability Forum (since December 2005)	• Discuss issues confronting government stakeholders in the financial system with potential systemic impact, as informed by the financial institution supervisory committee • Coordinate and exchange information for synchronisation of laws and regulations concerning the banking system, non-bank financial institutions and the capital market • Coordinate implementation or preparation of specific initiatives in the financial sector	Chair: Minister of Finance Members: • Governor, Bank Indonesia • Chairman, Otoritas Jasa Keuangan • Chief Executive Officer, Indonesia Deposit Insurance Corporation

Malaysia	Financial Stability Executive Committee (since 2010)	- Decide on the provision of liquidity assistance and issuance of specific directives to non-bank financial institutions not regulated by BNM - Decide on financial assistance (capital support) to financial institutions regulated by BNM	Chair: Governor, Bank Negara Malaysia (BNM) Members: - Secretary General to Treasury - Chairman of Securities Commission Malaysia - CEO of Malaysia Deposit Insurance Corporation - A Deputy Governor of BNM - Up to two external experts
Philippines	Financial Stability Coordinating Council (since 2012)	Coordinating mechanism that identifies areas of brewing pressures and to take pro-active measures before these risks spillover	Chair: Governor, Bangko Sentral ng Pilipinas Members: - Bangko Sentral ng Pilipinas - Treasury - Securities and Exchange Commission - Insurance Commission - Philippine Deposit Insurance Corporation
	Financial Sector Forum (since 2004)	- Improve supervision of financial conglomerates - Address regulatory gray areas	Chair: Deputy Governor, Bangko Sentral ng Pilipinas Members: - Securities and Exchange Commission - Insurance Commission - Philippine Deposit Insurance Corporation
Thailand	Financial Institutions Policy Committee (since 2011) – formerly known as Financial Institutions Policy Board	- Formulate and execute policies relating to supervision and examination of financial institutions - Determine policies concerning financial institutions	Chair: Governor, Bank of Thailand Members: 2 Deputy Governors - Director of the Fiscal Policy Office - Secretary of Insurance Commission

		• Determine financial proportion, including prudential financial ratios for financial institutions • Provide an opinion or recommendation relating to the establishment of new financial institutions	• Secretary of Securities and Exchange Commission • 5 external experts
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Notwithstanding the trends observed in the inclusion of external members on financial stability committees, decisions on the provision of emergency lending to distressed financial institutions remain the exclusive authority of most central banks. This acknowledges the criticality of speed required in these decisions, and also the existence of important safeguards that have been built around such lending to protect central banks from exposures to financial losses. Central banks have generally developed strong frameworks for the provision of emergency lending which include a ready list of acceptable high-quality collateral against which lending is to be provided, prudent valuation methodologies that also provide for an appropriate level of haircuts, and processes for the assessment of an institution's continuing viability, particularly when lending is required to be rolled-over. There are exceptions in which the provision of emergency liquidity by the central banks has been subjected to the authority of an external committee or the Treasury. On closer examination, such exceptions have generally been where questions of viability are more likely to arise, in particular when it relates to institutions not directly supervised by the central bank. In Malaysia, liquidity assistance to such institutions that are not directly supervised by Bank Negara Malaysia (thereby rendering viability assessments more difficult) must be approved by a committee of BNM that includes external members. Another example can be found in the United Kingdom, where the Chancellor of the Exchequer holds the power in deciding on the provision of emergency liquidity assistance,²³ which is subsequently executed by the Bank of England.

Whether internal or external committees are used, the quality of financial stability decisions begins with strong internal central bank processes (including strong analytical frameworks and supporting structures) that support the decision-making process. There are different approaches to the internal organisation of financial stability functions within central banks. Some central banks have separately staffed and resourced departments dedicated to the management of financial stability, while in other central banks, this function is subsumed within the existing microprudential supervision or macroeconomic functions. How the financial stability function is organised within central banks is likely to be influenced to some degree by the hierarchy of the financial stability mandate (vis-à-vis price stability and other mandates of the central bank), the clarity of the mandate in the legislation and the powers conferred on the central bank. A study by the World Bank that focused on regulation and supervision aspects reported that three quarters of the

survey respondents from emerging markets and developing economies (EMDEs) have established a specialised department that focuses on financial stability and systemic supervision (Cihak et al, 2012b). In contrast, only 44% of central banks from advanced economies had dedicated units, usually within the macroeconomic or micro-supervision functions, that undertake financial stability analyses. Given the substantially stronger focus on the management of systemic risks following the global financial crisis and broader financial stability mandates being given to central banks, there is a cause for central banks to review and enhance the manner in which financial stability issues (including information flows) are coordinated internally and externally. This should contribute towards improving existing organisational arrangements to maintain a clear focus on the identification and management of systemic risks and to generally support more effective coordination.

7. Cooperation and Coordination Across Agencies and Across Borders

One important change in the management of financial stability has been the increased emphasis placed on having in place and ensuring the effective operation of cooperation and coordination arrangements (CCAs) across agencies and across borders. This is reflected in the Basel Committee on Banking Supervision (BCBS) Good Practice Principles on Supervisory Colleges²⁴ and the recently revised (September 2012) BIS Core Principles for Effective Banking Supervision, which has substantially expanded the methodology for assessing compliance with principles relating to coordination for the purpose of financial sector assessments carried out under the IMF/World Bank Financial Sector Assessment Program.

Effective CCAs have become more critical for a number of reasons. Financial innovation and increased market sophistication have deepened the interlinkages between the different parts of the financial system and introduced new channels through which risks which can threaten financial stability are transmitted. Not all of these channels are within the span of direct control and influence of central banks. As discussed in the previous section, policy instruments for responding to financial stability risks can also be dispersed across multiple agencies, requiring coordination between these instruments to optimise their combined effect and avoid over-adjustments. The expansion of activities of financial groups beyond their domestic markets as well as greater capital mobility across borders as a result of increased liberalisation adds a further cross-border dimension to the management of financial stability that cannot be ignored. Consequently, central banks and other financial stability authorities have become more inter-dependent both at the national and cross-border levels.

CCAs supporting financial stability are generally structured to achieve four key objectives: (i) to facilitate the prompt identification and assessment of systemic risks; (ii) to manage potential cross-border effects of regulation and supervision, particularly in the implementation of global reforms and the regulation and supervision of systemically important financial institutions; (iii) to coordinate policy responses to reduce risks to financial stability; and (iv) to provide clarity in the roles and responsibilities of relevant authorities in the management and containment of crises. Given these objectives,

CCAs have mainly focused on information-sharing arrangements; commitments to consultations on key policy initiatives, in particular those having an impact on the mandates of other authorities; and cooperative efforts to enhance the capacity and overall resilience of the financial system, for example in the deepening of financial markets in the region and the provision of cross-border liquidity support such as that facilitated through the cross-border collateral agreements²⁵ which have been advanced among EMEAP²⁶ countries. In the area of resolutions, the establishment of cross-border crisis management groups (CMGs)²⁷ is expected to enhance the state of preparedness of relevant authorities in dealing with potential cross-border spillovers from the failure of systemic financial institutions with significant operations in multiple jurisdictions. To work effectively, CMGs will need to be inclusive, with well-defined arrangements dealing with the roles and responsibilities of the authorities concerned and safeguards to support timely information flows between authorities.

In the more recent period, there have been increasing trends towards establishing more formal arrangements for cooperation and coordination between central banks and other authorities, including through cooperation agreements that set out in substantial detail how authorities intend to cooperate with each other in the management of financial stability both during normal times and in crises. Some of these agreements may be grounded in law, such as the Strategic Alliance Agreement between the central bank and the deposit insurance corporation in Malaysia. Central banks may also have specific legal obligations to consult with other authorities on policy matters that may affect the mandates of other authorities. These developments have had an important role in promoting a shared view of important financial stability outcomes, and in establishing priorities for coordination towards contributing to those outcomes.

Confidentiality concerns and constraints continue to present some challenges to central banks in efforts to improve important information flows under CCAs for the purpose of managing systemic risks. In many cases, legislative solutions will be needed to overcome these challenges. In Malaysia for instance, provisions were built into the Central Bank of Malaysia Act 2009 to enable the central bank to share information and cooperate with other supervisory authorities within and outside Malaysia for the purpose of promoting financial stability. This includes the specific coordination of financial stability measures.

Even with formalised gateways for information-sharing, equally important are the operational protocols and secure platforms for sharing and handling sensitive information before the challenges can be fully resolved. This needs to be put in place well before a financial crisis is imminent in order to provide confidence among the different agencies involved to share critical information during a crisis when agencies are likely to be more guarded in sharing sensitive information, particularly in a cross-border context. Such protocols may address when information is shared, who it will be shared with, and binding obligations to ensure the protection of the information shared. It is also important to agree in some detail the purpose of information-sharing arrangements. This in turn will define the nature, level of detail, and timing of information to be shared which should be fit-for-purpose. One clear objective of

cross-border information-sharing arrangements is to inform the policy responses of central banks where risks of cross-border contagion are likely to be high. This allows an opportunity for central banks and other financial stability authorities to implement coordinated responses to mitigate the risks and avert wider spillovers. An example of this was the synchronised announcement of government blanket deposit guarantees by the central banks of Malaysia, Singapore and Hong Kong in 2008 to contain the spillover effects from the global financial crisis.

Building trust and understanding, which are preconditions for CCAs to work effectively, takes time. In practice, it will be important for authorities to establish the CCAs during normal times, so that there will be confidence that they will function when tested by the immense pressures during a crisis. This should include nurturing a strong culture of collaboration within central banks, developing new skills that may be needed to manage more complex external relationships, and ensuring on an ongoing basis that the arrangements are practicable under different potential scenarios.

8. Accountability and the Financial Stability Mandate

The issues around central bank accountability are a subject of extensive debate given the broad powers provided for central banks to perform their functions and the relevance and implications of central banks' actions for wider constituents. Earlier sections of this paper have discussed the importance of clarity in the financial stability mandate and its related objectives and powers which are important components of the accountability framework for the performance of central banks with respect to their financial stability mandates. Appropriately organised decision-making structures and processes further promote ex-ante accountability and provide checks against the abuse of powers by central banks. This section discusses the different ex-post accountability frameworks that have been adopted by central banks.

In all central banks, oversight arrangements through a governing board exist for holding central banks accountable for the performance of their mandates. Variations, however, exist with respect to the scope of decisions that come directly under the authority of such governing boards. Decisions on financial stability policies and measures are more commonly taken by specialised internal or external committees which are held directly accountable for these decisions. This acknowledges the depth of specific knowledge and expertise involved in financial stability matters and their extensive implications which are likely to exceed the normal breadth of experience one might be able to achieve in a board that is generally charged with the oversight of the overall affairs of the central bank. In some countries such as Thailand, the legislation provides for the setting up of a few policy boards (not unlike external committees), one of which is focused on financial sector regulation and supervision. Decisions on financial stability matters must be approved by this board. This remains relatively rare. In most countries, reporting mechanisms are more commonly in place for central banks to keep the oversight board informed of financial stability developments and policy measures taken, and to explain these matters when required by the board.

Greater transparency in the decision-making process can also strengthen accountability frameworks that apply to the central bank's financial stability mandate. This is achieved in the same way that market discipline works, by releasing information such as minutes of meetings or public statements following key decisions which allow stakeholders to scrutinise the manner in which financial stability decisions were taken and to evaluate the considerations, circumstances and trade-offs leading to those decisions. For reasons discussed earlier in the paper, such transparency is usually provided only after a time-lag.

The accountability of central banks to the wider public is also provided through the obligation of central banks to report to an elected body such as a parliamentary committee and the government (typically through the Minister of Finance) on financial stability matters and on the general affairs of its business. In most cases, such obligations are legislated and can be quite specific as to the content, frequency and manner of reporting. For example, in Indonesia, the central bank is mandated by law to present to the House of Representatives the development of the central bank's activities every three months. For some central banks, there is also a mandatory requirement to table to the parliament the annual report which may contain matters pertaining to financial stability before such reports are released to the public.

An increasing number of central banks have leveraged on Financial Stability Reports (FSRs) to explain their assessments of risks to financial stability and how these risks are being managed. Publications of FSRs are commonly accompanied by briefings held by the central bank for the media, financial industry, analysts and in some cases, business sectors during which central banks have further opportunities to elaborate their assessments and actions. In addition to their relevance as a way in which central banks can be held accountable for their financial stability mandate, FSRs also have been positioned by central banks as an instrument to *promote* financial stability. This is achieved by providing information in FSRs that can improve the understanding of and contribute to dialogue on emerging risks to financial intermediaries, highlight potential implications for financial stability from the collective actions of individual agents in the financial system, and influence behaviours towards reducing risks that are building up in the financial system or strengthening buffers that will improve the resilience of financial intermediaries to stress (Cihak, 2006). Given the limited frequency of publication of FSRs, central banks have also used other means, such as speeches and interviews given by senior central bank officials, to maintain confidence in the financial system and to highlight any emerging concerns.

9. Central Bank Independence and Financial Stability

Independence represents one of the core pillars on which the effectiveness of the central bank depends. In the aftermath of the global financial crisis, the issue of central bank independence has come under increased scrutiny. The time consistency problem in monetary policy where longer-term horizons of policies conflict with shorter-term expectations of economic agents has been well established as a primary motivation

for the independence of central banks. This is to ensure credibility in the conduct of monetary policy. This is equally relevant in the sphere of financial stability policy. Such independence is necessary to promote credible and consistent rules and regulations for financial stability which are not subject to short-term pressures and undue external influence.

A frequently cited example of when such pressures can arise is in the management of the trade-offs between curbing credit-fuelled speculative activities in order to prevent the build up of financial imbalances over time through the tightening of prudential regulations, and the potential growth moderating effects these measures might have in the short-term. During normal times, views on the costs and benefits of such measures to the financial sector and to the wider economy may be widely divergent. This is compounded by the fact that the immediate costs of macroprudential policy measures are highly visible while the effectiveness of such policies may only be observed over the medium and longer term. Even then, the lack of clear evidence in the absence of financial instability or crises often brings into question the necessity of such measures. Given the wide-ranging implications of such measures, affected parties may be prompted to attempt to influence the decision-making process. As the causes of financial instability and the necessary policy responses have yet to be fully appreciated, a bias in favor of delayed action can often prevail. Insulating the financial stability authorities from pressures by the market, industry or lobby groups is therefore important to maintain credibility and support for the effective implementation of financial stability policies.

The issue of independence is also particularly contentious when frameworks for holding central banks accountable for financial stability have yet to be fully developed. These issues are not, however, insurmountable. The elements of governance that have been discussed in the earlier parts of this paper provide the essential underpinnings for a strong foundation for central bank independence in performing its role in safeguarding financial stability. Having clarity on the central bank's mandate for financial stability, with clear goals and the necessary powers supporting that mandate, is a key element that needs to be in place if independence is to be gained. The combination of clarity of the mandate reinforced by the necessary powers allows the central bank to be judged on whether the actions taken to achieve the stated goals were appropriate and whether in fact, they yielded the desired results.

For most central banks, the autonomy and independence for the mandate for monetary stability is conferred in the legislation whereby the law clearly defines the goals and objectives of the mandate, as well as the rules by which these goals are achieved, thereby providing a strong link between the monetary stability mandate and the corresponding powers to achieve the mandate. As noted in the earlier part of this paper, there have been recent moves to legislate the financial stability mandate in a similar manner to give clarity to the mandate in the law. In doing so, it provides clarity on the expectations of the central bank and the objectives for which it will be held accountable, without which it would be difficult to accord independence to central banks for the financial stability mandate.

A further important element supporting the independence and autonomy of the central bank with respect to the financial stability function is the oversight arrangements over the performance of the central bank in achieving the goals of the financial stability mandate. This includes a robust decision-making process and increased transparency in how the central bank manages financial stability, thereby ensuring that effective checks and balances are in place. As discussed in the earlier parts of this paper, such oversight arrangements have ranged from central bank boards to parliamentary committees that provide oversight to varying degrees in keeping under constant review the performance of central banks in achieving their objective of financial stability, and ensuring the responsible use of its powers and resources for this purpose. This ensures that decisions of the central bank are aligned to its mandated role and mitigates the risk of a misuse of powers and improper conduct by the central bank.

Ensuring independence throughout the stages of the economic cycle will also require sound structures and arrangements to manage conflicts between the financial stability and the other mandates of the central bank; appropriate mechanisms to escalate the decision-making process to wider stakeholders; effective channels for engagement across relevant authorities involved in financial stability; and having more developed frameworks for effective financial stability communications. These arrangements are even more important for emerging economies where the mandate for central banks is also broader including having a developmental role that may require extensive coordination with the government and other relevant agencies.²⁸

The pursuit of central bank independence in managing financial stability is confronted with two main challenges. The first concerns the growing demand for greater transparency through prior consultation on the financial stability measures, while managing the implications that such consultation can sometimes have on the intended effects of financial stability measures. Consultations are clearly desirable when the objective is to generate wider debate and dialogue that will help to clarify proposed policies, prepare industry for their implementation and to gauge their likely impact and costs in advance. However, in crisis-related situations, or when conditions exist which give rise to systemic concerns affecting the functioning of the financial intermediation process or the orderly functioning of the financial markets, the speed of action required may not allow for advance consultations to take place. Under these circumstances, a robust decision-making process, clear communications on the central bank's assessments of financial stability risks, and the release of information and further explanations on the decisions after the fact, would lend support for trust and confidence in the central bank, and respect for its independence.

The second challenge concerns the need for central banks to coordinate with other regulators and agencies, including the government, while avoiding compromised actions that can undermine the objectives of the financial stability mandate. Central banks from different parts of the world have addressed this need for coordination by establishing various inter-agency committees and councils with different governance arrangements having different implications for the central bank's autonomy and

independence. Given that the need for coordination is particularly important in the management of a financial crisis, it has been suggested that a distinction be made between normal and crisis times.²⁹ It is suggested that independence during a crisis “*is neither possible nor desirable*” but that in the post crisis period the central bank should then “*re-establish its independence*.” It is well recognised that someone has to take the lead during a crisis in making key decisions – whether it is to provide emergency liquidity or to nationalise or close down an institution. The issue is then whether this decision should more appropriately be taken by an elected official given that it may involve taxpayer monies and have wider implications for public interests at large.

While there is a general consensus on the need for greater engagement and on the need to leverage on information and assessments from other relevant authorities, there have been differences concerning the lead authority for this process. Alternative arrangements exist with respect to the establishment of coordinating committees and councils for this purpose. In the US, the Secretary of the Treasury chairs the Financial Stability Oversight Council, while in Australia, the Governor chairs the coordinating council.³⁰ In the more complex conditions during a crisis, clarity on the objectives to be achieved and the explicit governance arrangements for the decision-making process (thus ensuring accountability), provide the basis for the independence of the central bank even during a financial crisis. Particularly when the central bank also has the responsibility for the regulatory and supervisory oversight function in addition to the lender of last resort function, the central bank is relied upon to take into consideration all factors from the different parts of the financial system to support its assessment of the financial stability conditions and to make decisions that would be in the best interest of the nation. Frequently, institutional arrangements for this purpose are endorsed by legislation and provide the parameters and conditions under which the actions can be taken.³¹

Collectively, the accountability, oversight and decision-making arrangements are elements that provide the foundations for autonomy and independence in the central bank’s mandate for financial stability. Central bank independence can thus be preserved with the right arrangements in place to ensure accountability. Given the conditional nature of this independence and its relation to governance and accountability, the level of central bank independence with respect to its financial stability mandate will continue to evolve over time.

10. Institutional Capability for the Financial Stability Mandate

To maximise the effectiveness of the central bank in performing its financial stability mandate, it will also need to be supported by a reinforcement of its institutional capability. This is to enable the central bank to be well equipped to deliver the key outcomes under the financial stability mandate. Recognising the changing contours of the financial landscape both at the national and international levels, this institutional capability needs to be periodically reviewed to ensure its continued relevance and effectiveness. This has not only prompted central banks to review the structure, frameworks and governance practices for the central bank’s financial stability mandate

but, as noted earlier in this paper, to also redesign its internal structures and approaches and to accord increased resources towards strengthening their financial stability capability.

The main areas of focus have been to strengthen the surveillance capabilities of the central bank, taking into account domestic and international developments that will have implications on financial stability; to improve the early detection of risks and vulnerabilities including the channels of contagion through which risks are transmitted; to strengthen the formulation of micro- and macroprudential policies; and to enhance capabilities in the area of crisis management and resolution. Greater liberalisation and the globalisation of finance and the resulting increased international interconnectedness of financial systems have further increased demands for central banks to develop new capabilities for supporting a more comprehensive approach to surveillance and policy formulation that takes into account perspectives beyond domestic considerations, and to have the ability to perform constructively in a more integrated approach to crisis management that involves other financial systems. In the more recent times, there has also been an increasing focus on market conduct and consumer protection. In emerging economies, the further development of the financial system has also been given important attention given its significance in supporting the financial stability mandate.

The internal institutional capacity of central banks to deliver the financial stability mandate must also critically include the ability to leverage on new technologies, and having the right talent in place, including at the senior leadership levels. Given that the economic and financial landscape is being dramatically transformed to become more complex with increased uncertainties, central banks will need to critically review their existing internal capability which may no longer be sufficient for the continued effectiveness of the institution. The central bank's talent pool needs to have new skill sets and competencies around integrated analytical thinking, complex problem solving under multiple scenarios and the ability to make sound judgments and manage wide-ranging tradeoffs. The nature of the financial stability mandate also requires central bankers to be able to work collaboratively, and manage complex relationships with significantly enhanced communication skills. In most emerging economies, talent with these new capabilities is in short supply. Central banks are also confronted with competition from the industry and from other parts of the world for talent with these similar skills and competencies. In addressing these challenges, central banks require comprehensive frameworks for managing human capital that are targeted and more focused on building these new capabilities across the dimensions of recruitment, progression, capacity development, retention and rewards at all levels of the organisation.

The financial stability mandate will also need to be supported by high quality data and information. The data sources need to be significantly broadened to take into account the changing financial landscape and to consider the adequacy of the systematic risk indicators that are being monitored. There is also a need to strengthen the research and analytical functions of the central bank and continuously improve the application

of models used for stress testing, risk management and assessments of conditions in the financial system under a wide range of scenarios. The use of multi-disciplinary teams that can collaborate effectively to aggregate and interpret different types of information – financial and non-financial, macro and micro, quantitative and qualitative – will become more important, requiring new skills to combine assessments in an integrated manner and potentially covering areas that are not traditionally associated with central banking. Flows of information within the central bank will increasingly need to leverage on multiple sources of information with clear paths for information to be shared horizontally across microprudential, macroprudential and macroeconomic functions of the bank, and to be escalated vertically for the deliberation of issues and decision-making by management. In preserving the confidentiality of information shared, particularly market-sensitive information, central bank practices have ranged from allowing relatively free flows of information across functions within the central bank, to practices that enforce strict restrictions on access to only the highest levels of the organisation.

Achieving the requisite level of institutional capability to effectively discharge the financial stability mandate in the more challenging environment is a significant undertaking for any individual central bank. For this reason, central banks in the different regions in the world have pooled efforts, resources, and expertise for their mutual benefit to enhance their organisational capability. In the Asian region, this has been facilitated through platforms such as The SEACEN Centre which has had an important role in advancing research and talent development initiatives for the region, focusing in particular on supporting the financial stability mandates of its member central banks.

11. The Role of The SEACEN Centre

The SEACEN Centre was formally established in 1979 by a number of central banks in the Asian region to provide a platform for the exchange and sharing of information to facilitate greater cooperation in the area of central banking. The year 2013 marks 31 years of The SEACEN Centre's existence and contribution to central banking development since its incorporation as a legal entity in 1982. Its central bank membership has now increased from eight members to 19, also including among its members the three central banks of the large economies in Asia, comprising Bank of Korea (1990), People's Bank of China (2011) and Reserve Bank of India (2013).

From its initial years, the programmes of The SEACEN Centre were already focused on supporting the financial stability mandate. The Centre's flagship Financial Stability and Banking Supervision programmes have now trained more than 3,000 participants. Since 1987, The SEACEN Centre has also held annual meetings for the directors of supervision which have fostered the broad exchange of information and sharing of experiences that have contributed towards building stronger financial systems in the region. The first annual meeting of the Deputy Governors in-charge of financial stability and banking supervision was convened in 2010 to discuss issues and matters related to financial stability. Through these meetings, arrangements for

greater cooperation and collaboration in the area of financial stability have also been strengthened. In the more recent years, the Centre has partnered with the Financial Stability Institute of the BIS and the Toronto Centre for Leadership in Supervision to further enhance the capacity building programs offered to central banks in the area of financial stability.

With over 30 years of history in serving the central banks in the Asia-Pacific region through its learning programmes, research work, and networking and collaboration platforms for capability building in central banking, The SEACEN Centre is well placed to support the capacity of central banks in delivering their financial stability mandate. Recent and upcoming initiatives by The SEACEN Centre underscore the potential for the Centre in fostering thought leadership in financial stability. This includes the publication of the SEACEN Financial Stability Journal and the proposed establishment of a Policy Working Paper series that will generate high-quality research and build a strong knowledge base in financial stability issues within the context of the Asia-Pacific region; as well as the proposal to set up the SEACEN Supervisory Issues Discussion Room, an interactive web-based platform that will serve as a forum for supervisors in the region to deliberate on policies and challenges of central banks in safeguarding financial stability.

The SEACEN Centre's efforts additionally include conferences and training on current issues in financial stability to provide further avenues for the sharing of central bank experiences across the region and the development and implementation of capacity building programmes which are more tailored to specific needs and issues faced in individual economies. These initiatives have been reinforced with the establishment of the SEACEN Advisory Group for Banking Supervision and Financial Stability in 2009 to provide specific feedback on the Centre's various learning and development initiatives. An outcome of this process has been the introduction of a comprehensive banking risk curriculum covering credit, market, operational and liquidity risks.

Over the years, The SEACEN Centre has also undertaken a series of collaborative research projects in the financial stability area among member central banks, including on strengthening financial stability indicators in an environment of rapid financial innovation and addressing the changing nature of risks in promoting financial stability. A signature research project for 2013 will focus on the theme of the SEACEN 30th Anniversary Conference which is 'Greater Financial Integration and Financial Stability.' These projects provide a platform for international academics, policymakers and industry leaders to provide thought leadership on contemporary financial stability issues and developments. Case studies have also been developed in the areas of assessing systemic financial market infrastructure and on the challenges and opportunities in implementing Basel III, while simulations on crisis management have been jointly conducted with the Toronto Centre.

Given the rapid pace of financial integration in Asia, in particular, among the ASEAN region and ASEAN+3, which will involve further financial liberalisation,

more interconnected financial market infrastructures and increased cross-border trade and financial flows, there is an even greater role for The SEACEN Centre to contribute towards the strengthening of the institutional capability of the central banks to deliver their financial stability mandate and to foster greater regional cooperation and collaboration among central banks in the Asia-Pacific region.

12. Conclusion

The events of the global financial crisis have prompted a fundamental re-thinking of financial stability frameworks. Central banks around the world are being confronted with issues that arise from a significantly expanded role in financial stability. This role has also become more contentious in several respects, notably in relation to the potential conflicts that arise with the central bank's monetary policy mandate and the more extensive powers for financial stability accorded to central banks. Important steps are being taken to provide greater clarity around the central bank's financial stability mandate and to identify the range of attendant powers required for central banks to deliver that mandate. In a more complex financial world, financial stability powers are necessarily wide, raising important questions around how decisions on the use of these powers are made, and how to hold central banks properly accountable. Defining financial stability goals more clearly is an important starting point. This is reinforced through varying arrangements that exist across central banks to achieve better coordination, decision-making and accountability. These arrangements also provide the basis for securing an appropriate degree of independence of central banks with respect to the financial stability mandate.

In meeting the challenges associated with the financial stability mandate, central banks must continue to invest in strengthening their institutional capability. New skills will need to be developed, and existing frameworks, structures, tools and processes will need to be continuously enhanced. The task is a challenging one for any individual central bank and opportunities should be leveraged to pool resources and efforts among central banks to strengthen their individual and collective capacity to effectively deliver the financial stability mandate and in the process, contribute towards preserving financial stability in the region.

Zeti Akhtar Aziz is the Governor of Bank Negara Malaysia since 2000. She has had an important role in the successful transformation of the financial system in Malaysia including overseeing the enactment of eight new major legislation for the financial sector. Dr. Zeti is also actively involved in strengthening regional financial integration in Asia. She chaired the regional taskforce that prepared the report for future financial cooperation in the region. A founding member of the BIS Asian Consultative Group for Asia, she was also the first co-chair of the Financial Stability Board Regional Consultative Group for Asia. She has also had an important role in global development of Islamic finance. Dr. Zeti received her PhD in Economics from the University of Pennsylvania.

Endnotes

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2. See also Nier (2009).
3. Including central banks in the United Kingdom, Australia, Canada, Japan, South Korea and China.
4. Eichengreen, Prasad and Rajan (2011) argue that monetary policy should be regarded a legitimate part of the macroprudential supervisors' toolkit.
5. Especially under explicit deposit protection systems with a financial back-stop by the Government.
6. See Chant (2003), Crockett (1997), Ferguson (2002) and Mishkin (1999).
7. Speech by Benoit Coeure, Member of the Executive Board of ECB, Frankfurt, 2013.
8. During the global financial crisis, large financial institutions in the US received capital support under programmes and transactions backed by the Treasury and Federal Reserve. This included the Troubled Asset Relief Programme, the takeover of Fannie Mae and Freddie Mac, and the Maiden Lane Transactions which supported the bail-outs of Bear Stearns and the American International Group.
9. Examples include prohibitions on lending to specific non-bank institutions and the requirements for Treasury approval to extend the Federal Reserve's liquidity programmes to such institutions.
10. BIS Report on Central Bank Governance and Financial Stability (2011). The report was produced based on a study undertaken by the Central Bank Governance Group under the chairmanship of Stefan Ingves, Governor Sveriges Riksbank.
11. Position in 2009 drawn from a BIS survey published in the report on Central Bank Governance and Financial Stability (2011).
12. European Banking Authority, European Insurance and Occupational Pensions Authority and European Securities and Markets Authority.

13. Report on Central Bank Governance and Financial Stability (2011).
14. International Accounting Standards Board (IASB), Basel Committee on Banking Supervision (BCBS), International Association of Insurance Supervisors (IAIS), International Organisation of Securities Commissions (IOSCO).
15. G20 Working Group Report on “Enhancing Sound Regulation and Strengthening Transparency” published on 25 March 2009.
16. A Discussion Paper entitled Instruments of Macroprudential Policy, issued by the Bank of England in December 2011.
17. See Table 4 of this article for further details on the FSEC.
18. The 2008 supervisory reform in Austria sought, among other things, to clarify the supervisory responsibilities and optimize the communication interfaces between the Oesterreichische Nationalbank (OeNB) and the Financial Market Authority (FMA). While the FMA remains the independent integrated financial supervisory authority, OeNB assumes all operational responsibilities in respect of all on-site inspections and off-site analysis (which were formerly shared with the FMA). Under this new arrangement, OeNB is now responsible for overall risk assessment (or fact finding) while decision making functions are entrusted with the FMA.
19. Consultative Document on Countercyclical Capital Buffer Proposal issued by the Basel Committee on Banking Supervision in December 2010.
20. The moderating effect of such capital buffers on credit expansion during the build up phase was considered a “positive side effect”, helping “to lean against the build-up phase of the cycle in the first place”.
21. See Goodhart (2011).
22. Also highlighted in a report from the Central Bank Governance Group entitled Issues in the Governance of Central Banks issued by the BIS in May 2009.
23. Defined as support operations outside the Bank of England’s published frameworks, as contained in the Memorandum of Understanding on Financial Crisis Management published in December 2012.
24. Issued by the Basel Committee on Banking Supervision in October 2010.
25. Cross-border collateral arrangements are reciprocal arrangements between central banks which allow internationally-active banks to obtain liquidity abroad from host central banks by pledging home-currency denominated securities through their respective home central banks.

26. Executives' Meeting of East Asia-Pacific Central Banks.
27. As advocated in the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board (2011).
28. Also see Reddy (2011).
29. Blinder (2012).
30. Also see Table 4 of this article on SEACEN Economies with Committees for Financial Stability that include External Members.
31. An important example is legislation for resolution authority.

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Financial Stability Insights from Recent IMF/World Bank FSAP Assessments

By **Michael J. Zamorski** and **Vincent Choon-Seng Lim**

1. Introduction and Background

The International Monetary Fund (IMF or the Fund) and The World Bank conduct¹ periodic assessments of member countries' overall financial stability through their Financial Stability Assessment Program (FSAP). Mandatory FSAP assessments are conducted at least every five years for the 25 jurisdictions deemed to have systemically important financial sectors.² Countries' FSAP results are published by the IMF in "Financial System Stability Assessment" reports (FSAP Reports), accessible on the IMF's website.³

Maintaining financial stability is essential to achieving sustainable, long-term economic growth. Since the onset of the Global Financial Crisis (GFC) of 2007-08, financial stability issues have received priority attention from financial sector policymakers and international standard-setters. The FSAP assessment approach was revised in 2009, incorporating lessons learned from the GFC, to achieve more forward-looking, "systematic, candid and transparent" assessments.⁴

Many countries conduct periodic financial stability self-assessments, using criteria and approaches similar to those employed in the FSAP. Self-assessments inform policymakers about potential risks and vulnerabilities to financial stability. They can also determine whether a jurisdiction's financial stability infrastructure and approaches meet international standards. In the interest of transparency and public accountability, many countries publish their self-assessments.

2. Significance of the Study

The IMF/World Bank commenced their FSAP reviews in 1999, after the 1997 Asian financial crisis and other costly and disruptive episodes of financial instability and banking system crises over the last several decades, many of which involved multiple jurisdictions.⁵

FSAPs are a critical part of the IMF's on-going surveillance activities, providing independent assessments of the strength and resiliency of countries' economies and financial system infrastructure.⁶ These evaluations are primarily based on on-site missions and other field work performed by experienced teams of trained assessors, which include subject matter experts in various aspects of financial stability.

While FSAPs' coverage and scope for different countries are similar, they are not identical. They are tailored to a country's stage of economic development, and the composition, size and complexity of its banking system and financial markets. FSAP Reports are quite detailed and contain a wide variety of findings, conclusions and recommendations for remedial action, reflecting the diverse characteristics of the

countries being reviewed. In addition, while the FSAP Report is the core country assessment document, there are frequently multiple supporting documents that provide more detailed analyses and commentary supporting overall FSAP conclusions.

FSAPs frequently focus on the strength and resiliency of the countries' banking sectors, given banks' typical importance in providing credit. That same emphasis was evident in the FSAPs we reviewed, hence our focus on banking sector stability.

It is important to understand the lessons learned and financial stability insights contained in post-GFC FSAP Reports. Persistent fragilities in many of the major developed economies, regional vulnerabilities, and various linkages and transmission channels could precipitate future periods of instability or crisis. Proactively identifying and addressing potential risks and vulnerabilities are essential to avoiding or dampening periods of instability or crises, and reducing the potential for contagion. This article is intended to provide insights to assist Asia-Pacific countries as they benchmark and enhance their own financial stability self-assessments.

3. Research Methodology

Twenty-two country FSAP Reports, with more than 1,500 pages of detailed comments and conclusions, were published from 1 January 2012 through 31 August 2013, based on country missions and field work performed during 2011 to 2013.⁷ This group of FSAP Reports was selected for analysis as the assessed countries represent a broad cross-section with respect to their stage of development, size and complexity. Also, the timing of the FSAP field work and missions for the assessments was sufficiently after the GFC to allow reasonable clarity in understanding how it impacted those jurisdictions, and the lessons learned from the crisis. Nine of the 22 countries have systemically important financial sectors.⁸

Our analysis and commentary are not intended to be an empirical study based on the frequency of similar FSAP findings. There are numerous variables and chains of causation that can impact financial stability within a particular country or region. Frequency of a particular FSAP observation does not necessarily convey its relative importance, nor lend itself to a meaningful statistical analysis. In this article, we focus on specific FSAP Report findings which, in our professional judgment and experience, are most relevant to the Asia-Pacific region.

4. Key Points of Emphasis in Recent FSAP Reports

The 22 FSAP Reports evaluated multiple financial stability factors (and factor interactions), including: countries' current macroeconomic conditions, past economic performance, the impact of the GFC, potential vulnerabilities, systemic resiliency to internal and external shocks, conformity of financial sector supervisory and regulatory arrangements to international standards, and crisis management preparedness and resolution infrastructure.

From the 22 FSAP Report sample, we identified three core areas which received greater emphasis compared to pre-crisis FSAP Reports:

- Observance of International Regulatory and Supervisory Standards
- Macroprudential Stress Testing of the Banking Sector
- Crisis Management and Resolution Arrangements

These areas of emphasis are not surprising given the severe impact of the GFC on the banking sector, and the severe time pressures that national authorities faced to take decisive action to preserve public confidence in banks and markets and contain the crisis.

5. Observance of International Regulatory and Supervisory Standards

The Bank for International Settlements (BIS), Basel, Switzerland, owned by the world's central banks and monetary authorities,⁹ hosts the following regulatory and supervisory standard-setting committees that cover the indicated financial industry sector/infrastructure:

- Basel Committee on Banking Supervision (Basel Committee or BCBS) – Banking¹⁰
- International Association of Insurance Supervisors (IAIS) – Insurance
- International Association of Deposit Insurers (IADI) – Deposit Insurance Systems
- Committee on Payment and Settlement Systems (CPSS) – Payment and Settlement Systems

Additionally, the International Organization of Securities Commissions (IOSCO), Madrid, Spain, issues standards for securities (capital markets) regulation and supervision, and the Financial Action Task Force (FATF), Paris, France, promulgates “legal, regulatory and operational measures for combatting money laundering, terrorist financing and other related threats to the integrity of the international financial system.”¹¹

FSAP teams assess countries' compliance with the following minimum standards for sound regulatory and supervisory practice¹²:

- Basel Committee: “Core Principles for Effective Supervision” (known as the Basel Core Principles or BCP), originally issued in 1997, revised in 2006 and 2012
- IAIS: “Insurance Core Principles, Standards, Guidance and Assessment Methodology,” as amended in 2012
- IOSCO: “Objectives and Principles of Securities Regulation,” as augmented in 2010
- CPSS: “Core Principles for Systemically Important Payment Systems,” issued 2001
- CPSS-IOSCO: “Recommendations for Securities Settlement Systems,” issued 2001

- CPSS-IOSCO: “Recommendations for Central Counterparties,” issued 2004
- CPSS-IOSCO: “Principles for Financial Market Infrastructures,” issued 2012
- IADI: “Core Principles for Effective Deposit Insurance Systems,” jointly issued with the BCBS in 2009
- FATF: “International Standards on Combatting Money Laundering and the Financing of Terrorism & Proliferation,” issued 2012.¹³

The 22 FSAP Reports contain comprehensive analytical and systematic investigation into compliance with international regulatory and supervisory standards. FSAP teams assess countries’ compliance with international standards for sound regulatory and supervisory practice covering the banking, insurance and securities (capital markets) industries, payment and settlement systems, deposit insurance arrangements and financial crimes prevention.

In the 22 FSAP Reports analyzed, the condition of the banking sector was closely correlated to an economy’s overall financial stability and performance. This reflects the importance of banks as the primary intermediaries of credit and counterparty risk in these countries, and also the main source of systemic risk. In view of these circumstances, our analysis focuses on the BCP. The BCP provide a framework to assess whether regulatory jurisdictions meet the essential preconditions or minimum standards necessary to have sound and effective bank supervision programs.

5.1 FSAP Reports and the Basel Core Principles Assessment Methodology

The 2006 BCP contains 25 individual core principles (CPs), supplemented by a separate “Core Principles Methodology,”¹⁴ specifying the criteria for assessing CP compliance, the definition of the grading system, and other practical considerations in conducting assessments. Each CP is intended to apply to the prudential supervision of all banks, ranging from large, complex internationally-active banks to small, non-complex deposit-taking institutions. The BCP recognize that supervisory resources should be allocated in proportion to the risk profile and systemic importance of banks.¹⁵

The 2006 BCP structure covers the following seven topical assessment clusters, with the related range of CPs parenthetically indicated:

1. Objectives, independence, powers, transparency and cooperation (CP 1)
2. Licensing and structure (CPs 2 to 5)
3. Prudential regulation and requirements (CPs 6 to 18)
4. Methods of ongoing banking supervision (CPs 19 to 21)
5. Accounting and disclosure (CP 22)
6. Corrective and remedial powers of supervisors (CP 23)
7. Consolidated and cross-border banking supervision (CP 24 and 25)

Assessment criteria identified and articulated for each of the CPs are designated as either “Essential Criteria” (“minimum baseline requirements for sound supervisory practices universally applicable to all countries”) or “Additional Criteria” (“supervisory practices that exceed current baseline expectations but will contribute to the robustness of individual supervisory frameworks”).¹⁶ FSAP CP assessments cover compliance with only the Essential Criteria, though a country can voluntarily choose to also be assessed against the Additional Criteria.

All of the 22 FSAP BCP assessments were conducted using the 2006 methodology. Parenthetically, as of 31 July 2013, no FSAP Reports have yet been published which use the 2012 revised BCP assessment criteria.

5.2 Major Findings of the FSAP Reports Based on the BCP Assessment

Twenty of the 22 countries sampled had previously received at least one prior FSAP assessment. The overall level of BCP compliance was generally satisfactory as most countries had taken action to address prior FSAP findings of less than full compliance. Nevertheless, there were instances of partial or noncompliance with individual CPs. The relative gravity and circumstances of CP noncompliance varies, with some new instances of noncompliance arising out of less than satisfactory experiences before and during the GFC with respect to effective CP implementation.

The remainder of this section highlights what we consider to be, in our professional judgment, the most important areas of recurrent noncompliance with the referenced CPs’ Essential Criteria, listed in numerical order. The text reflects our opinions and interpretations of pertinent portions of the referenced CPs and related FSAP commentary.

5.2.1 *Objectives, Independence, Powers, Transparency and Cooperation (CP 1)*

Some basic shortcomings in these areas were observed across multiple countries. These are:

(1) *Inadequate resourcing of bank supervision*

For supervision to be effective, it must be performed by qualified professionals in a manner that allows for timely detection and mitigation of excessive risk. Some jurisdictions lacked budget autonomy or failed to provide sufficient resources to attract and retain adequate staffing and expertise.

Efforts to augment bank supervisory staff need to take into account the training needs for new hires. Training programs for new bank supervisors, which frequently include apprenticeship training, may take several years for new hires to achieve the necessary degree of proficiency. Therefore, the benefits of increasing competent staff may be delayed due to training needs.

In addition to a high degree of technical competency, effective bank supervisors need to possess good judgment, a healthy degree of professional skepticism, and be able to communicate effectively and persuasively with the highest levels of bank management and boards of directors. Therefore, their training should also emphasize “soft skills” development.

(2) *Lack of legal protections for bank supervisors*

Some jurisdictions lacked proper legal protections for bank supervisors, which should be enacted in law. Supervisors should be shielded from political pressure and the threat of lawsuits for actions taken or decisions made in good faith in discharging their official duties. Otherwise, such threats could inhibit bank supervisors from taking necessary actions to curtail excessive risk or other unsound practices. Statutory immunity should be extended to include coverage of any litigation costs.

(3) *Inability to legally exchange confidential supervisory information with domestic and foreign financial sector supervisors*

Effective cooperation and information-sharing arrangements among domestic and foreign supervisors are essential to understanding and overseeing risk in more complex banking organizations, such as those with multi-tiered corporate structures, mixed (banking and commercial) groups, and cross-border operations. Supervisors who lack the legal authority to share confidential information will likely be unable to adequately assess prudential risks, and thus unable to properly fulfill their supervisory responsibilities.

5.2.2 Capital Adequacy (CP 6) and Risk Management Process (CP 7)

Supervisory authorities should establish and enforce prudent minimum capital adequacy requirements for banks. Internationally-active banks should have minimum capital requirements at least equal to applicable Basel Committee requirements (CP 6). Additionally, the CP 7 Essential Criteria require that bank supervisors determine that banks have capital adequacy assessment processes that provide for maintenance of capital levels that are commensurate with their risk profiles. Also, for those countries that have implemented the Basel II capital requirements, supervisors should ensure that banks have an effective Internal Capital Adequacy Assessment Process (ICAAP) to enable the banks’ boards of directors to determine and substantiate their own capital adequacy assessment and strategy.

The FSAP assessment teams found that some countries: (1) set minimum capital requirements too low or did not fully specify their ICAAP expectations; and (2) did not have procedures to require that additional capital charges be imposed when supervisors identified additional material risks not previously taken into account by banks in their ICAAP.

5.2.3 Problem Assets, Provisions and Reserves (CP 9)

Bank supervisors need to confirm that banks adequately evaluate and control risks in problem assets, with clear loss mitigation strategies and timely loss recognition. Adequate bank policies and procedures should be in place to ensure that provisions for possible loan losses result in maintenance of “adequate” reserves for loan losses. Bank documentation should therefore substantiate that reserve levels realistically reflect the level of risk inherent in related credit portfolios.

Banks also need to recognize loan impairments and other asset loss exposures (such as real estate acquired through foreclosure) in a timely manner. Failure to establish adequate reserves and take timely asset write-downs is an unsafe and unsound practice, which can result in material overstatement of a bank’s earnings and capital. Such misstatements could result in the publication or submission of erroneous, false or misleading information to the public and regulatory authorities. Regulators rely on this information for off-site monitoring, so its accuracy is critical.

The FSAP Report sample disclosed fundamental shortcomings in this area, even in several advanced countries. Cited deficiencies included inadequate procedures for reviewing the adequacy of banks’ loan loss provisioning and loss recognition procedures, and, in some cases, there was not even supervisory review of these areas during on-site inspections. This type of analysis would normally be embedded in problem asset review processes.

5.2.4 Large Exposure Limits (CP 10)

Adequate risk diversification is a basic tenet of sound banking practice. Concentrations of risk have been a primary or contributing factor in past banking crises. Countries should set and stringently enforce prudential limits on bank risk exposures to single counterparties or groups of connected counterparties.

The FSAP reports stress the need for bank supervisors to ensure that banks have adequate policies and procedures to identify and manage asset concentrations. Some countries’ supervisors did little or no review of banks’ concentrations risks. In some cases, limits on large exposures were not sufficiently stringent or not enforced.

5.2.5 Corrective and Remedial Powers of Supervisors (CP 23)

Bank supervisors need to not only possess appropriate legal authority related to safety and soundness oversight of the banking sector, but also to actually take timely action to identify and mitigate excessive risk or unsound conditions or practices. The sampled FSAP Reports conclude that several countries seemed reluctant or slow to exercise supervisory powers in developing problem situations, allowing problems to worsen. In addition, regulatory interventions in the case of weak or failing banks were too slow, or the legal authority to intervene (such as prompt corrective action¹⁷)

was not stringent enough, allowing nonviable banks to continue operating, increasing ultimate resolution costs.

5.2.6 Consolidated Supervision (CP 24) and Cross-border Banking (CP 25)

Increasing integration and conglomeration in the financial services industry have opened up possibilities of greater efficiency through increased economies of scale. Banks are increasingly owned by holding companies or other corporate parents. There may be multiple ownership layers between a bank and its ultimate parent. Each commonly owned/controlled affiliate, and the bank itself, may have subsidiaries. Some banks operate as part of complex group structures or conglomerates. Affiliated organizations, including bank affiliates, may be located in different countries. Non-bank affiliates may also be engaged in activities closely related to banking or financial services, and may engage in business transactions with each other. Some countries allow banks to be part of mixed groups, in which banks are affiliated with, or owned by commercial businesses.

The complex nature of financial institutions poses several problems to supervisors. First, complex ownership structures, lack of access to information, or other opacities can impair supervisors' ability to assess and control risk in a financial conglomerate. Second, transactions with affiliates, or problems in affiliated organizations, can adversely impact banks' safety and soundness. Third, contagion risk¹⁸ can spread quickly through a group via intercompany transactions and also pose reputational risk. Fourth, problems in large conglomerates and mixed groups could pose financial stability risks to the countries in which they operate.

Consolidated supervision is a long-standing, fundamental principle and essential element of effective bank supervision, which seeks to determine the financial soundness of a bank, taking into account the financial soundness and risks posed by affiliate relationships, as previously mentioned. As the Basel Committee recently reaffirmed, bank supervisors should have "...the necessary powers, authority and resources to perform comprehensive group-wide supervision of financial conglomerates...(and) ensure financial conglomerates have robust governance, capital, liquidity and risk management frameworks."¹⁹ Moreover, the 2012 revisions to the BCP require that banking supervisors should be able to supervise banking groups on a consolidated and on-going basis.

Surprisingly, despite the longstanding requirement that bank supervisors practice consolidated supervision, the 22 FSAP Reports disclosed that some countries, which have banks that operate within group structures or conglomerates, do not comply with this fundamental standard. Some cited shortcomings include:

- the lack of legal authority to review the overall activities of a banking group
- no legal authority to exchange confidential supervisory information with foreign supervisors
- having, but not exercising, legal authority to review group information

6. Macprudential Stress Testing in the Banking Sector

Compared to pre-GFC reports, current FSAP approaches to identifying and quantifying risks and vulnerabilities to countries' financial sectors place strong emphasis on comprehensive macroprudential stress testing. In the past, while some degree of stress testing was utilized, financial sector surveillance was focused on tracking various Financial Soundness Indicators (FSIs) for the banking industry, such as overall capital levels, credit and counterparty risks, asset growth, profitability, and liquidity.

FSIs, while useful, have analytical limitations as they mostly provide a static view of risk. Stress testing, though it also has limitations, produces a more dynamic, forward-looking analysis that considers a range of outcomes based on multiple scenarios. This allows better identification and understanding of financial stability risks and vulnerabilities.

The need to expand forward-looking analysis is reflected in the extent and sophistication of FSAP stress testing in post-GFC FSAPs. All 22 FSAP assessments included macroprudential stress testing of the strength and resiliency of the countries' banking systems. FSAP teams reviewed countries' stress testing methods and results, typically performing supplemental testing using their own baseline and multiple adverse or shock scenarios. The FSAP teams also tested risk factors that countries' had not previously tested.

FSAP stress testing methods included:

1. Scenario analysis with changing risk factors due to foreseeable (plausible) future events
2. Maximum loss approach, assuming "worst case" scenario/extreme events
3. Contagion analysis, which considers exposure to the overall financial system from the transmission of shocks from individual financial institutions
4. Network analysis (similar to contagion but with cross-border spillovers), based on bilateral exposures of banking systems across countries
5. Analysis of potential cross-border knock-on effects of banking sector distress on the nonbank and sovereign sectors of each country
6. Reverse stress testing simulating the severity of individual and multiple risk factors needed to pose systemic risk

Common FSAP "top down" banking system stress test scenarios included:

- Industry capital levels needed to meet international standards with appropriate buffers
- Industry liquidity levels needed to meet international standards with appropriate buffers
- Industry capital levels before and after single and multiple shocks
- Upward and downward parallel shifts in yield curves

- Liquidity/systemic risk impacts of shocks, including deposit runs
- Estimates of possible central bank liquidity support in response to various shocks
- Impact of depletion of foreign exchange reserves

6.1 Major Findings of the FSAP Reports on Stress Testing

Many of the 22 FSAP reports recommended that central banks/monetary authorities refine and expand stress testing activities, which may require additional resourcing and expertise. Banks supervised by these authorities conduct stress testing using different models and approaches. Central banks that have bank supervisory oversight responsibilities should, therefore, have the expert capability to validate and cross-check individual bank results to ensure overall consistency. In countries where banking system stress testing is conducted by national authorities outside the central bank, there should be appropriate communication and collaboration with those authorities. In addition, stress testing protocols should integrate both micro- and macro prudential analysis, and be expanded beyond the banking sector.

Comprehensive stress testing may require systems thinking beyond national borders (e.g., network analysis models) by taking into account international linkages and dynamics. In this regard, stress testing capabilities are generally currently not able to produce reliable output that considers cross-border dynamics. However, supervisors can exchange relevant cross-border risk information to inform the risk assessment process.

While stress tests are a useful tool, the lack of data or poor data quality sometimes inhibits their reliability. Complexity and sophistication of stress testing models do not necessarily guarantee reliable results. For example, data and model limitations have been found to limit the ability of banks to identify and aggregate exposures across the wider financial system (BIS 2009). These limitations restrict the ability to expand scenarios that can be tested and, therefore, limit the quality of analyses that can be generated. As is the case with other financial modeling tools, outputs need to be expertly interpreted, with appropriate judgmental “overrides” applied in making analytical conclusions.

In summary, while recognizing the foregoing limitations, stress testing can greatly enhance central banks’ ability to identify potential financial stability threats and inform related policy decisions. Therefore, central banks should devote the necessary resources to build and enhance such analytical infrastructure.

7. Crisis Management and Resolution Arrangements

The GFC demonstrated that authorities did not always have sufficient legal powers or crisis management capabilities or infrastructure to deal with financial instability or systemic crises. These powers are needed to enable timely and decisive action to control risk and preserve public confidence in the banking system in order to contain a crisis. Crisis management planning also minimizes ad hoc decision making

in the midst of a crisis that can increase costs and have unintended and unforeseen consequences. The 22 FSAP assessments noted the need to address the following specific weaknesses:

- Insufficient crisis management planning
- Insufficient specification of roles of national authorities in a crisis
- Insufficient legal powers to take various emergency actions in a crisis
- Insufficient information-sharing arrangements with relevant authorities both domestically and cross-border
- Insufficient or nonexistent arrangements for providing emergency liquidity to banks
- Insufficient specification of failing/failed bank resolution strategies/options
- Not conducting crisis simulation exercises

It is recommended that central banks and other authorities should seek necessary legal authorities to deal with a broad range of potential crises. They should periodically conduct crisis simulation exercises including all relevant parties to assess the efficacy of such arrangements under multiple crisis scenarios. Formal interagency agreements can clarify beforehand the roles and responsibilities of various national authorities in a crisis.

The introduction of an explicit deposit insurance scheme that conforms to IADI core principles was a recurrent FSAP recommendation. Also, crisis management and resolution arrangements should consider cross-border operations. Cross-border coordination arrangements can include participation in cross-border crisis management groups and establishing effective crisis communication systems among supervisors of cross-border banking groups.

8. Conclusions and Recommendations

What are the main implications of the FSAP assessments and related action items for policymakers? We have six recommendations in that regard:

1. Conduct stringent, periodic country self-assessments using the FSAP approach with the participation of other relevant national authorities
2. Take timely action to address risks and vulnerabilities identified from self-assessments
3. Ensure a comprehensive supervision framework is in place that conforms to the Basel Core Principles
4. Ensure compliance with other international standards and codes related to financial sector supervision and oversight
5. Ensure effective crisis management and resolution arrangements are in place to deal with any crisis situations that may develop
6. Organizational training and human capital management should result in the acquisition and retention of top quality talent and expertise to ensure ongoing effective implementation of the preceding recommendations

The FSAP analytical framework provides a very useful guide to policy-makers and supervisors to construct and fine-tune their approaches to attaining, preserving and monitoring financial stability. However, it must be emphasized that risky practices usually emerge and proliferate during good times. Accordingly, financial stability self-assessments should be purposely stringent to effectively identify potential issues and risks. Related remedial action can then be taken to help avert or dampen future periods of instability or crisis.

The BCP were revised in 2012 to maintain their relevance as a global standard of good practice, by incorporating lessons learned from the GFC, and feedback from the IMF and World Bank FSAP process.²⁰ The BCBS encourages bank supervisory authorities “...to move towards the adoption of updated and new international supervisory standards as they are issued.”²¹

Accordingly, central banks should coordinate with other relevant national authorities to conduct self-assessments using the revised 2012 BCPs as part of their efforts to promote financial sector stability. However, it must be emphasized that the ultimate test of supervisory effectiveness depends upon whether a country’s actual implementation of the BCP, and the prudential regulator’s supervisory culture and practices, allow for the timely detection and curtailment of imprudent risk-taking, or other unsound practices, at their incipient stages.

Adequate human capital, training programs that promote continuing professional development and a strong legal framework are prerequisites for attaining and maintaining an effective program of financial sector supervision and regulation that conforms to international standards and codes.

The Asian financial crisis of 1997-98 was particularly noteworthy for its sudden onset and contagion effects, with the crisis spreading quickly to other countries, indicating the many close inter-linkages and potential transmission channels for cross-border contagion. Comprehensive consolidated supervision of the banking sector is therefore especially critical in view of the many sizeable banking groups that operate across multiple countries in the Asia-Pacific region. In this regard, effective cross-border coordination and information-sharing arrangements are essential, including both on-going supervision and crisis preparedness.

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Endnotes

1. The respective FSAP roles and responsibilities of the IMF and World Bank are detailed in The Financial Sector Assessment Program, Factsheet, (Washington, D.C.: IMF, last updated March 15, 2013), available at <http://www.imf.org/external/np/exr/facts/fsap.htm>: “FSAP assessments are the joint responsibility of the IMF and World Bank in developing and emerging market countries and of the Fund alone in advanced economies, and include two major components: a financial stability assessment, which is the responsibility of the Fund and, in developing and emerging countries, a financial development assessment, the responsibility of the World Bank.” With respect to assessing financial sector stability, “FSAP teams examine the soundness of the banking and other financial sectors; conduct stress tests; rate the quality of bank, insurance, and financial market supervision against accepted international standards; and evaluate the ability of supervisors, policymakers, and financial safety nets to respond effectively in case of systemic stress. While FSAPs do not evaluate the health of individual financial institutions and cannot predict or prevent financial crises, they identify the main vulnerabilities that could trigger one.”
2. The Financial Sector Assessment Program, Factsheet, (Washington, D.C.: IMF), last updated March 15, 2013.
3. A searchable index of FSAP and ancillary reports issued from 2001 to the present is available at <http://www.imf.org/external/np/fsap/fsap.aspx>. This page also contains links to IMF documents that provide an in-depth discussion of the FSAP process and related matters. IMF surveillance and FSAP assessment activities for a jurisdiction are sometimes conveyed in multiple reports, each providing detailed assessments of a particular risk area or assessment of international standards and practices observance. Overall FSAP findings may incorporate or reference the findings of these reports in an overall country assessment, which is presented in a “Financial System Stability Assessment” report, commonly referred to as an “FSAP report.”
4. Financial Sector Assessment Program: Frequently Asked Questions, (Washington, D.C.: IMF, last updated October 03, 2012), available at <http://www.imf.org/external/np/fsap/faq>
5. Laeven, Luc and Valencia, Fabian, “Systemic Banking Crises: A New Database,” Working Paper No. 08/224, (Washington, D.C.: IMF, September 1, 2008); (Working Papers do not represent the views of the IMF).

6. The views expressed in FSAP reports are "...based on the information available at the time (they were) completed... (and) the views expressed...are those of the staff team and do not necessarily reflect the views of the government of (the jurisdiction being assessed) or the Executive Board of the IMF." Further, each FSAP report reviewed for this article contained the following, or substantially similar, qualification: *"FSAP assessments are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAP assessments do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud."*
7. The twenty-two country FSAP reports analyzed for this article were published by the IMF on the parenthetically indicated dates, with each report having an "IMF Country Report" identification number ("IMFCR"): Mexico (March 30, 2012, IMFCR 12/65); Israel (April 2, 2012, IMFCR 12/69); Saudi Arabia (April 18, 2012, IMFCR 12/92); Spain (June 8, 2012, IMFCR 12/137); Czech Republic (July 17, 2012, IMFCR 12/177); Brazil (July 31, 2012, IMFCR 12/206); Japan (August 1, 2012, IMFCR 12/210) ; Tunisia (August 13, 2012, IMFCR 12/241); Turkey (September 7, 2012, IMFCR 12/261); Australia (November 15, 2012, IMFCR 12/308); Republic of Slovenia (December 6, 2012, 12/325); France (December 21, 2012, IMFCR 12/341); Republic of Armenia (January 11, 2013, IMFCR 13/10); India (January 15, 2013, IMFCR 13/8); Colombia (February 22, 2013, IMFCR 13/50); Malaysia (February 28, 2013, IMFCR 13/52); The Bahamas (April 11, 2013, IMFCR 13/101); Republic of Kosovo (April 12, 2013, IMFCR 13/99); Belgium (May 17, 2013, IMFCR 13/124); Nigeria (May 28, 2013, IMFCR 13/140); Uruguay (May 31, 2013, IMFCR 13/152); and the Republic of Poland (July 23, 2013, IMFCR 13/221).
8. Mexico, Spain, Brazil, Japan, Turkey, Australia, France, India, Belgium.
9. Sixty central banks are listed as having rights of voting and representation according to "The BIS in profile," (Basel: BIS), June 2012, available on-line at <http://www.bis.org/about/profile.pdf>
10. The BCBS, founded in 1974 and the oldest of the BIS standard-setters, provides a forum for international cooperation on bank supervisory matters, develops standards and sound practices for the global banking industry, and encourages convergence toward common approaches.
11. Details concerning the mandate and activities of the FATF are available at <http://www.fatf-gafi.org>
12. Standards issued by BIS-hosted financial sector standards-setters (BCBS, IAIS, IOSCO, CPSS and IADI) can be accessed through from their website at <http://www.bis.org>

13. Link: http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf
14. BCBS, “Core Principles Methodology,” October 2006, (Basel: BIS).
15. BCBS, “Core Principles for Effective Banking Supervision,” September 2012, (Basel: BIS), p. 5.
16. BCBS, “Core Principles for Effective Banking Supervision,” September 2012, (Basel: BIS), pp. 7-8.
17. Prompt corrective action, also known as PCA, refers to banking laws that mandate increasingly stringent operating restrictions on undercapitalized banks, up to and including license revocation. The general objective of PCA is to close nonviable institutions or transfer their operations to new ownership well before book capital is zero or negative, to minimize losses. PCA frameworks usually mandate more stringent restrictions as capital levels decline, and there can also be liquidity triggers for mandatory restrictions. Restrictions can include dividend prohibitions, curtailment of non-deposit borrowings or asset growth, and executive compensation limitations.
18. Contagion risk in this context is the risk that financial weaknesses or problems in one affiliate can be transmitted to affiliated organizations through various mechanisms.
19. BCBS/Joint Forum, “Principles for the supervision of financial conglomerates,” September 2012, (Basel: BIS), p. 3.
20. The 2012 BCP revisions are available at <http://www.bis.org>
21. BCBS, “Core Principles for Effective Supervision,” September 2012, (Basel: BIS), p. 5.

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Organizing for the Supervision of Bottom of the Pyramid Product Providers

By **Nestor A. Espenilla, Jr.** and **Pia Bernadette Roman Tayag**

1. Introduction: The Bangko Sentral ng Pilipinas' Approach as Supervisor and Regulator

1.1 Risk-Based Approach

The Bangko Sentral ng Pilipinas (BSP) adopts a risk-based approach to the supervision of the banking system. This approach not only provides a more efficient allocation of resources based on identified priorities but is also more adaptive to the growing complexity of the banking business. A risk-based approach allows the BSP to better channel its resources in critical areas that need more supervisory attention.

This move away from a compliance based approach, which started to take place in 1997, enables the BSP to instead focus on evaluating the banks' quality of oversight, adequacy of policies and procedures and ability to implement them, as well as the robustness and effectiveness of the risk management and internal audit functions (Espenilla, 2007). Hand in hand with this, the BSP also works toward ensuring that an enabling policy and regulatory environment is in place to allow flexibility for innovations in business models, space for the provision of a wide range of products and services, and opportunities for entry into new markets by the banks (Espenilla and Roman Tayag, 2011).

This environment thereby provides the banks with greater latitude to undertake activities and take on risks as long as they have the ability to manage said risks and absorb any resulting losses from the said activities. This arrangement builds on the basic proposition that it is in the banks' inherent interest, and therefore the onus rests on the bank's leadership, to ensure that their banking business thrives, innovates, remains competitive while continuing to operate in a safe, sound and stable manner. This approach is closely complemented by a financial stability view where the BSP monitors the market holistically to ensure that the interaction of market players, products and services do not result in market behavior that may lead to severe market disruption and even financial crisis.

1.2 Offsite Monitoring/Supervision and Data Collection and Management

Integral to this risk-based approach is the ability to balance complementation of offsite and onsite monitoring. An effective offsite monitoring mechanism that yields an updated assessment of the changing risk profile of a banking unit serves as a valuable input to the scoping and planning of an onsite examination. On the other hand, the report from an onsite examination which presents significant supervisory conclusions is integral in updating the risk profile assessment of the bank (Espenilla, 2007).

In this paper, emphasis is being made on offsite monitoring in light of the role it plays in ensuring that the BSP can assess the risk profile of a bank at any given time and its directional activities that can impact its risk profile. This enables the BSP to thoroughly understand and be updated on the business of the bank, including any new products and services that it is positioning to provide. Robust and updated data collection and management are crucial in this regard. Toward this end, the BSP has crafted a comprehensive Financial Reporting Package (FRP), fully aligned with International Accounting Standards for enhanced financial transparency. Together with the FRP, Bank Performance Reports (BPR) which monitor ongoing financial performance of banks are captured in a Data Warehouse System that can be used to perform various analyses by the supervisor.

In addition to these institutionalized data collection and management, targeted surveys are also conducted by offsite supervision to inform the BSP on certain trends, identified areas of risks as well as possible opportunities. All these form part of the supervisory information framework which aims to enhance the ability to assess the adequacy and appropriateness of the banks' risk assessment processes particularly for its products and services.

International guidance papers also provide additional information on the possible supervisory approach to particular products and services. The Basel Committee for Banking Supervision (BCBS), for instance, has published several papers on risk assessments for particular products, providing an indicative though not exhaustive list of risk areas that supervisors should be mindful of. However, these are usually for sophisticated or mainstream products that do not cover innovations currently being targeted to the bottom of the pyramid (BOP) market.

2. New Bank Products and Services for the Bottom of the Pyramid Market

Many businesses have targeted providing goods and services to the poorest people in the world. Pralahad and Hart (2002) make a case for the fastest growing new markets and entrepreneurial opportunities being found among the billions of poor people at the bottom of the (financial) pyramid. Similar interest has been burgeoning in the financial system with the reality that an estimated 2.5 billion adults do not use formal financial services to save or borrow (Financial Access Initiative, 2009). The opportunity is vast for those who are willing to develop products and services or even transform business models to serve this significantly untapped market.

In the Philippines, the figures of "unbanked" continue to present a challenge that must be addressed. While continued banking reforms and efforts at strengthening the system to allow strong banks to expand their operating networks have borne fruit, there still remains 37% of municipalities in the country that do not have a banking office. Concentration of banking services are also biased toward higher income areas, leaving much of the low income areas significantly underserved. The National Capital Region (NCR) alone accounted for 43% of the total number of deposit accounts, 68% of the total peso volume of deposits and 87% of the total outstanding loans in the

banking system (BSP, 2012). Other data indicate that almost 27% of Filipino adults have a formal savings account and only 10.5% had a loan from a formal financial institution in the last 12 months prior to the conduct of the survey (World Bank, 2012).

Some headway has been made in reaching out to these unbanked areas and population, particularly through the development of microfinance, and more recently through technology driven delivery channels. These are welcome developments in making the system more inclusive. Yet, while these present a vast array of social and economic opportunities, they also present some risks that need to be addressed.

3. BSP Approach to Assessing Risks in BOP Products and Services

Making the system more inclusive, where there is effective access to financial services for all, is held to be a worthy policy objective and one that is complementary if not mutually reinforcing with the BSP's more traditional objective of maintaining financial stability. Financial exclusion causes adverse effects in the economy and especially makes people more vulnerable to financial distress, debt and poverty. Mobilizing broad based savings also allows greater depth and diversity in the financial system that can contribute to its overall resiliency. In addition, sound and stable financial systems are necessary for long-term, balanced and inclusive growth as it directly contributes to social cohesion and shared economic development.

Consistent with these principles, the BSP strives to maintain the delicate balance of creating an environment flexible to innovation while managing the attendant shifts in the magnitude of risks or the changing nature of the said risks. New products and services may also bring to fore changes in the interaction with existing risks faced by the bank. It must be ensured that useful innovations are not stifled, but instead be allowed to operate in an environment where the risks associated with such innovations are adequately understood and addressed, and where there is a judicious and proportionate application of sound prudential supervision principles.

At the end of the day, the BSP looks at the ability of the banks to deliver these new products with the appropriate risk management processes. Banks will still need to demonstrate the ability to assess, control and monitor the risks as well as the agility to adjust to new risks. While this is the focus of the supervisor, it is incumbent that the supervisor is also aware of market developments to make informed assessments of banks' individual risk management processes for particular products. Since the market for BOP financial products is a relative greenfield for banks and the technology positioned to reach this market is dynamic, it is important that supervisors develop a sufficiently deep appreciation of how to balance the risks to banking operations with the benefits that can be derived for further innovations.

Aside from informing its possible supervisory and regulatory approach, the bank supervisor also needs to be abreast with market developments as a consideration for broader concerns such as financial system stability, integrity and consumer protection.

In addition to the institutionalized manner in gathering information as discussed above, the BSP also recognizes the importance of appropriate market surveillance on issues that may present risks and opportunities or the use of other mechanisms to gather useful information.

In early 2013, the BSP developed and launched a high level product catalogue to provide a snapshot of available products and services that have novel features tailored to cater to markets that are not traditionally served by the formal financial system (i.e., youth, microenterprises, low income salaried workers). A carefully selected sample of banks was asked to discuss such products and services designed to serve such niche markets. This tool, in addition to our other data gathering and offsite initiatives, could be seen as institutionalized market surveillance to enable us to know the developments in the market. There are still limited product catalogues in other jurisdictions yet they have proven to be useful to identify policy opportunities, barriers or gaps; validate effectiveness of policies; and determine whether there are risks (i.e., financial stability, Anti-Money Laundering (AML), consumer protection) inherent in the products.

This general approach of fully understanding and knowing relatively new products and services before developing a definite supervisory and regulatory approach can be described as a “test and learn” approach or a “learn then do” approach. The proportionate and judicious application of existing standards and regulations cannot be determined without the supervisor’s understanding of the product/service or business model.

The BSP can offer two tangible examples of this approach to emerging products and channels positioned to serve the BOP market: microfinance and mobile financial services.

3.1 Microfinance

The General Banking Law of 2000 mandated the BSP to recognize microfinance as a legitimate banking activity and to set the rules and regulations for its practice within the banking sector. At that time, microfinance was mainly provided by civic-oriented institutions or by for-profit institutions mainly for corporate social responsibility purposes. The “traditional” bankers tend to shun providing services to clients with no track record, no collateral and informal documentation of their cash flows. Yet, globally, microfinance was proving to be an excellent double bottom line proposition of profitability and social development. Thousands of entrepreneurial poor were being provided much needed access to financial services that enabled them to grow their businesses and improve the quality of their lives.

Cognizant of the above, the BSP’s policy and regulatory approach is to enable the delivery of commercially sustainable microfinance products by the banking sector. The BSP defines microfinance as a wide range of financial services that banks may deliver under various permitted modalities – credit, savings, insurance and fund transfers or remittances for the low-income population. This definition acknowledges that the

BOP market, like mainstream financial consumers, require a variety of appropriately designed products that can address their need for enterprise financing; savings and fund transfers for household emergency and liquidity management; and insurance protection from contingent events and economic shocks.

Regulations clearly define the features of each of the above products, and provide guidance to banks on how these can be safely and sustainably delivered. For example, a microdeposit, which is a “no-frills” small savings account targeted for the poor, must have a minimum maintaining balance not exceeding PhP100 (approximately US\$2), an average daily balance of PhP40,000 (approximately US\$900) and not be subject to dormancy charges. Another example is a microenterprise loan, which must be below PhP150,000 (approximately US\$3,000), used to finance a micro or small entrepreneurial activity, and frequently amortized as befits a client’s cash flow.

Also worth noting is how microfinance regulations are complemented by consumer protection rules, specifically those on transparency and disclosure. Like all regular loans, interest on microenterprise loans must be computed using the declining balance method, and disclosed using a standard format prescribed by regulations. This is to ensure that low-income clients are not unduly disadvantaged by misleading disclosures of interest rates and other fees associated with the loan transaction.

BSP regulations not only focus on product definitions and consumer protection but also on duly authorized providers, in recognition that the delivery of microfinance services requires providers to possess specialized capacities and an appreciation that serving the BOP is viable business. To support the entry of new providers, the BSP provided a mechanism wherein unregulated microfinance institutions can transform or formalize into regulated institutions. This allowed pioneer microfinance non-government organizations (NGOs) to establish banks that are covered by BSP supervision. Regulations were also set in place to guide existing banks that wanted to provide microfinance services. While rural banks (or village banks) and thrift banks (or savings banks) were expected to be well-positioned to cater to microfinance needs in the countryside, the regulations provide them with flexibility to make their own business decisions about entering the microfinance market.

In crafting policies and regulations, the BSP learned from successful microfinance lending practices around the world, recognizing and accepting best practices such as using group support or liability arrangements, cash flow based lending, and high frequency amortizations that match a client’s cash flow. The BSP also maintained open communication with pioneers in microfinance within the banking sector, to stay informed of market developments but more importantly to fully understand the risks associated with the business to be able to develop a proportionate policy and regulatory response.

It is in fully understanding the products that the BSP was able to map its main risk areas and determine the minimum requirements to ensure commensurate management of the identified risks. As an example, BSP regulations ensure adequate

credit risk management of the microloan portfolio of banks. The measure of Portfolio-at-Risk (PAR) and strict provisioning requirements address the greater risk of default if a microfinance client misses even one amortization to pay a relatively short-term and small value loan. This is a tangible illustration of how the objectives of financial inclusion can be proportionately balanced with the prudential considerations that underpin financial stability.

In the table below, some of the BCBS' "Core Principles of Effective Banking Supervision" are mapped against the requirements we have set in place to ensure risk management while recognizing the peculiar characteristics of microfinance.

Table 1. BSP Approach to Regulating Microfinance Services

Core Principles of Effective Banking Supervision	BSP Regulations
Definition of Microfinance	Clearly define microfinance as a provision of a range of financial services to low income clients/ entrepreneurial poor – credit, savings, insurance, and fund transfers. Microfinance loans have specific characteristics (i.e., cash flow based, frequent amortization, etc.)
Capital Requirements/ Adequacy, Licensing Requirements	Banks comply with same standards and requirements for capital adequacy and licensing.
Credit Risk	Require banks to have clear underwriting standards and practices for cash flow based lending.
Risk Management/ Problem Assets/ Provisioning	Require high frequency monitoring of portfolio-at-risk and corresponding provisioning requirements reflecting peculiar risks of microfinance.
Governance	Specify necessary experience and track record in microfinance in the board and management. Impose clear and comprehensive governance standards.

As a supervisor, the BSP has been guided by this informed assessment of the product, which then also informed the appropriate supervisory approach. Internal capacity was also developed through the creation of a specialist examination group focused on the micro and SME finance business model. Developing deeper understanding of the business model informs the conduct of proportionate, risk-based supervision. In our CAMELS (bank performance and condition) assessment, we consider for example, that small loans to microenterprises may seem like a concentration of credit in an industry, but the loan books may actually be well diversified due to the large number of individual customers. A manual of examination procedures for microfinance consistent with the broader examination framework was also developed.

3.2 Mobile Banking through Electronic Money

Considering the foregoing discussions on the current demand for access to financial services in the country, it is worth noting that a study (Beshouri and Gravrak, 2010) showed that a large percentage of the country's unbanked has a mobile phone, nearly 60% of these unbanked mobile customers keep some form of savings, and 13% borrow from various informal sources. From a financial inclusion standpoint, these facts present an enormous and possibly even transformational opportunity. The depth and breadth of the reach of mobile phones as innovative service channels can be massively leveraged as possible access points for basic fund transfer activities, and with the appropriate linkages, for financial services.

The BSP recognizes that indeed technological innovations present a significant potential for increasing access to financial services. When the electronic money (e-money) product was presented to the BSP by the two leading telecommunication companies in the Philippines (one being presented as a product of a bank), the BSP endeavored to fully understand the product and its underlying technology and systems to appropriately identify the risks, the possible ways to address them, as well as other issues surrounding this novel application.

There was an understanding that aside from the risks associated with e-money, there is also a great degree of a changing nature of risks. In the table below, some of these changing risks were articulated by the BSP, side by side its potential benefits.

Table 2. BSP Approach to Regulating E-Money

	Changing Risks	Potential Benefits	BSP Approach
Customer/ User	• Limited information or misinformation • Lack of trust and capacity • Different customer experiences	• Potential of reaching the currently unserved	• Require consumer protection in the e-money regulations • Financial education
Issuer	• Entrance of new players, non-traditional providers (i.e., Telcos)	• Greater innovation • Wider reach • Higher efficiency	• Proportionate requirements for non-bank providers (i.e., risk management, capital, liquidity) • Ring fencing e-money operations • Transaction limits • Clear delineation between e-money and deposits
Agents	• AML issues • Agent fraud • Business case challenges	• Wider reach • Serving unserved areas • Broader ecosystem	• Regulation through the entity maintaining the agent networks

Consistent with the “test and learn approach,” the BSP approved the e-money products in 2004 and 2005 using existing applicable regulations. It was only in 2009, after fully understanding the risk areas, that the BSP issued the regulation on e-money. E-money was clearly defined as a surrogate for cash – an electronic stored value that does not bear interest, is not covered by deposit insurance, is prepaid and fully re-convertible to cash. It was clearly distinguished from deposit accounts and positioned to support retail fund transfers. The regulation further provided qualifications of e-money issuers particularly the non-banks (i.e., capital requirements, fit and proper standards); set clear rules in the issuance of e-money (i.e., transaction limits, anti-money laundering compliance, security features, and consumer protection); and identified parameters in the development of e-money agent networks (i.e., accountability of e-money issuers to accredit their agents).

Although e-money is primarily intended as an innovative, technology based payment channel for low value transactions, international standards on customer due diligence (CDD) and know-your-client (KYC) requirements are not foregone. E-money wallets can only be created when clients comply with mobile-based instructions to provide identity details. CDD is also repeatedly conducted every time a client transacts with a cash-in/cash-out agent. Regulations mandate e-money issuers to report suspicious transactions beyond the anti-money laundering threshold of PHP500,000 (approximately US\$11,000); and to establish an accessible consumer redress mechanism for concerns on e-money products.

The overall objective of the BSP policy approach is to create the environment that enables the creation of a broad, sound and proportionately regulated e-money ecosystem comprised of ubiquitous agent networks that can have a massive reach as potential outlets. Financial service providers can therefore build and leverage on this infrastructure to deliver their financial services.

By allowing banks to become e-money issuers or to outsource their e-money activities to technology providers or existing agent ecosystems, there is an opportunity to create linkages as well as broaden their reach and operating networks. The BSP will then ensure that such banks have the necessary risk management processes in place. To ably supervise and regulate these activities, we built up our own capacity by creating a Core Information Technology Specialist Group.

This approach is consistent with the BCBS study on risk management implications of electronic banking and e-money activities, which states that “a premature regulatory approach would run the risk of stifling innovation and creativity in these areas. Therefore, supervisors should encourage banks to develop risk management processes that are rigorous and comprehensive enough to deal with known material risks and flexible enough to accommodate changes in the types and intensity of such material risks associated with the electronic banking and electronic money initiatives” (BCBS, 1998, page 2).

3.3 Some Results

The discussions will be incomplete without the presentation of some of the results that have been brought about by the proportionate approach in assessing and controlling risks associated with new bank products and services for the BOP market.

For microfinance, positive results can be seen. From a handful of banks before 2000, there are now nearly 200 banks that provide microfinance services. This figure may only be about 29% of the total number of banks (nearly 700 banks which include commercial banks, thrift banks, and rural and cooperative banks) in the country, but these microfinance-engaged banks have become a consistent and stable source of financial services for more than a million microfinance clients. Worth pointing out is that microfinance has diversified in terms of product offerings which now include various types of microloans like housing and agriculture, and “microfinance plus” which addresses the need of growing microenterprises for loan amounts that are above the maximum threshold of a microenterprise loan.

Based on market feedback, there are indications that microdeposit clients are saving bigger amounts, which shows a greater appreciation of the value of having a deposit account. The banks are also now allowed to become distribution channels for microinsurance products, with premiums that are affordable for the BOP market, and underwritten by duly authorized insurance companies.

For e-money, there are now 24 e-money issuers that are banks, 3 are non-banks. These issuers currently have an agent network of nearly 15,000 cash in/cash-out agents and are continuously expanding. The number of e-money transactions as of year-end 2012 was over 180 million amounting to PHP613 billion. Banks have used e-money to allow their customers to transact with greater ease and lower costs. There is also the emergence of new banks whose business models rely heavily on the e-money platform and their distribution of financial services passes through the e-money ecosystem. E-money applications have also facilitated meaningful retail payments such as the delivery of the government’s conditional cash transfer pay-outs as well as person-to-government payments.

It can be said that the full understanding of the risks associated with the product by the supervisor enabled the design of a proportionate and facilitative supervisory approach that catalyzed the development and innovation in the offering of new products and services.

4. Guidance from International Standard Setters

It is said that the offering of bank products and services for the BOP may be an emerging area, yet there is an increasing global recognition of its significance in the development of stable and inclusive financial systems. Such recognition is made

in bodies like the G20 through the creation of the Global Partnership for Financial Inclusion. Standard setting bodies have also taken tangible steps that demonstrate their recognition that serving the “unbanked,” which is the essence of financial inclusion, could be complementary to their respective mandates.

The BCBS issued the guidance paper “Microfinance Activities and the Core Principles for Effective Banking Supervision” in 2010. More recently, the Basel Consultative Group has established a Financial Inclusion Workstream with the intent to update the said guidance paper to form an overall risk picture on financial inclusion. This would be of particular relevance to banking supervisors in exploring balance between financial inclusion and the broader supervisory objective of preserving the safety and soundness of the banking sector.

The BCBS likewise issued a guidance paper on “Risk Management Principles for Electronic Banking” (2003) to help develop the appropriate supervisory approaches to managing risks attendant to e-banking and e-money. The Committee on Payment and Settlement Systems (CPSS) created a Working Group on Innovative Retail Payments which intends to identify success factors of innovative retail payment instruments such as e-money, its implications to payment systems and the potential issues for central banks. This Working Group recently published its report (CPSS, 2012).

Supervisors can therefore look forward to more and clearer guidance which can help inform the crafting of appropriate and proportionate supervisory and regulatory approaches to the new bank products and services for the BOP market.

5. Concluding Remarks

In many developing countries, the banking system typically plays a very major, if not dominant role in the financial system. The role of effective banking supervision is therefore very important to promoting financial system stability and shall remain its primary focus. At the same time, the banking system cannot exist in a vacuum. There is significant scope to nurture opportunities for banks to develop appropriate financial services that are relevant and useful to BOP customers, which support virtuous inclusive growth dynamics. This presents an interesting and important challenge for bank supervisors to strike the right balance in shaping and enforcing a prudent but enabling regulatory environment.

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