Protecting the Whole * - A Review

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I. Introduction

The aftermath of the 2007 global financial crisis marked a turning point in financial system regulation, generating a "renewed" interest among global regulators in the use of macroprudential policy to promote financial system stability. In this regard, the article discussed some shortcomings of traditional regulation and promoted the need for a broader and systemic approach to financial system stability using both traditional (micro-prudential) and non-traditional (macroprudential) policies. The paper further discussed the elements of macroprudential policy and tools used to mitigate risks and vulnerabilities in the financial system. A summary of the article is presented in section II and comments are highlighted in section III.

II. Overview of Article

The article explained the deficiency of traditional "microprudential" regulation in guaranteeing the health of the financial system and thus, considered it as narrow in approach. First, it focuses only on the individually sound institutions. Second, it focuses less on financial institutions that operate in wholesale markets such as investment banks; and third, it neglects the possibility that an action considered as prudent behavior by one financial institution may indeed constitute a systemic problem when all financial institutions engage in similar actions-the herding approach. These seemingly drawbacks of traditional regulation was cited as one of the contributing factors to the global financial crisis that engulfed the world in 2007, which led to a growing interest in a more systematic and broader approach to financial system regulation. Consequently, macroprudential regulation has been considered as an additional and complementary tool to traditional financial system regulation, which is adapted to identify and counter growing risks and vulnerabilities such as credit, market, liquidity and systemic risks in the financial system. This enables regulators to minimize disruption in the provision of financial services and maintain financial stability. In practice, macroprudential policies include, but are not limited to the dynamic capital buffer, dynamic provisions, loan-to-value ratios, variation in sectoral risk weights, liquidity requirements, capital–risk weighted ratios and measures targeted at

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foreign currency lending. The dynamic capital buffer requires financial institutions to build-up their regulatory capital above required levels in periods of "unusually strong credit growth", or boom periods, which would allow such institutions to withstand or minimize losses in burst periods. Also known as countercyclical capital buffer, they are designed to minimize the boom and burst troughs in the business cycles. Similarly, dynamic provisioning requires financial institutions to make higher provision for loans in the period of boom and low provision in the period of slow business activities. Unlike the standard loan provisioning, these loan provisions are made in boom periods characterized by high loan repayments and low credit losses so that in burst periods, the "banks' balance sheet are better prepared to absorb losses". Differential sectoral risk weights are designed to ensure institutions make additional capital provision to cover loans in sectors with excessive risks. In this regard, the authors cited the Turkish example where there now exist stricter requirement for new lending to household sector to curb growing loan growth in that sector. Loan-to-value ratio simply refers to the creation of loans below the value of a property. In other words, it limits the "loan amount to well below the value of the property". According to the authors, this is often applied in the real estate market and complements the debt-to-income ratios, which limits the proportion of household income, spent on debt servicing.

Liquidity requirements 'coerce' institutions to increase buffers of liquid assets during boom periods which can be drawn down in burst times. The authors cited examples of countries that have introduced such measures as New Zealand and Korea. Measures targeted at foreign currency lending include portfolio limits on foreign currency lending and loan-to-value ratios for foreign currency loans. The authors, however, decried that recent emphasis by the Financial Stability Board on these tools have been directed only towards the "too big to fail" institutions and therefore urged for more attention to individually systemic bank and non-bank financial institutions. One such example includes financial institutions in the derivative market.

Having espoused some macroprudential tools, the authors stressed the need for international cooperation not only to minimize regulatory arbitrage, but also for the simple reason that domestic asset bubbles can be fed by foreign credit. They also advocated for the existence of institutional frameworks and the design of analytical frameworks to assess systemic risks to ensure effective macroprudential policies. While acknowledging the need for macroprudential policies to account for country specific circumstances, the authors noted that any designated institution should have a clear mandate to take prompt action to minimize the buildup of risks in the financial system. In addition, governments must be

supportive through its legislative policies in order to minimize systemic risks. For instance, political considerations and institutional arrangements sometime limit the deployment of macroprudential instruments which could jeopardize the stability of the financial system. Developing a system for early identification of systemic risks was also considered as an important element of effective macroprudential policy. In this regard, effective monitoring of several indicators of credit, market and liquidity risks as well as concentration in any sector should form part of the analytical toolkit such that the appropriate policy to address these growing risks is deployed. In conclusion, the authors reiterated the complementary role of macroprudential policy in the realm of monetary and fiscal policies. They pointed out the existing trade-offs between enhancing the stability and efficiency of the financial system in supporting economic growth. Thus, they stressed the need for an appropriate balance between benefits and costs of enhancing financial stability which often entails difficult judgments.

III. Comments

It is common knowledge that the world's view of stable monetary and financial conditions was threatened by the 2007-2008 global financial crisis, caused by a lax in financial system regulation and supervision (Canuto, 2011; Svensson, 2010).

Consequently, the traditional focus of central banking has been expanded to financial stability. Indeed, the 2010 Dodd-Frank Act in the United States stresses the importance of a regulatory framework to preserve financial stability in almost every section of the financial services industry with strong emphasis on taming the buildup of potential public liability from the failure of systemically important financial institutions (SIFIs). In most emerging market economies, including Nigeria, macro-prudential as a policy tool is not entirely a new phenomenon. In Nigeria, the Financial Services Coordinating Committee, (FSCC)[1] was setup in April 1994 as a formal platform with the aim of coordinating regulatory issues and concerns for the purpose of achieving financial stability and minimizing conflicts between prudential regulations. This platform, similar to the Financial Stability Oversight Council in US (created by Dodd-Frank Act) and recently the Financial Policy Committee within the Bank of England in United Kingdom provided institutional arrangement for anchoring financial system stability in Nigeria. Also, the structure

[1] *The committee has evolved over the years. In May 1994, the name of the Committee was changed to Financial Services Regulation Coordinating Committee (FSRCC), accorded legal status by the 1998 amendment to Section 38 of the CBN Act 1991 and formally inaugurated by the Governor of the CBN in May 1999. Its members have also evolved to recently include the Central Bank of Nigeria, Nigeria Deposit Insurance Corporation, Federal Ministry of Finance, Corporate Affairs Commission, National Insurance Commission, and Securities and Exchange Commission. See http://www.fsrcc.gov.ng/our-history.html for details.*

and composition of the FSRCC appears to have conferred the mandate of financial stability to all financial and non-financial regulating entities whose actions can impart on financial stability. Though this structure encourages cooperation and coordination among regulators, the issue of who takes ultimate or explicit responsibility for systemic risk could be a source of concern[2]. For instance, hitherto in England there was a tripartite structure between the Bank of England, the Financial Services Authority and the Treasury which shared the task of maintaining financial stability, but no institution was clearly responsible. It was not until April 2013 that the Bank of England, through legislation[3], was entrusted with the financial stability mandate which led to the establishment of the Financial Policy Committee within the Bank to 'monitor and respond to systemic risks'. Similar to Brazil, there is an active use of both monetary and macroprudential tools in Nigeria to achieve policy objectives. The Central Bank of Nigeria (CBN) is empowered by the 2007 CBN Act and Banks and Other Financial Institutions Act (BOFIA) to, and largely through its banking supervision, consumer protection and recently financial policy and regulation departments examine growing risks that could affect the efficient functioning of the financial system. Regulatory frameworks, policy guidelines and memorandum are also designed specifically to enhance prudential (macro & micro) supervision of the financial institutions to prevent the build-up of risks. Other key institutional arrangements include the publication of a half yearly financial stability report.

Macroprudential policy toolkits and its effects often vary depending on the economic conditions, reflecting the dynamics of the domestic financial system. Typical examples of macro-prudential tools deployed by the Central Bank of Nigeria include restrictions on loan-to-deposit ratio; liquidity ratio; cash reserve ratio; capital adequacy requirements; limits on borrowing, risk weights, corporate governance measures and disclosure requirements. The effectiveness of these policy tools vary, depending on the type of risks and their evolution. For instance, loan-to-deposit and liquidity ratios which are tools aimed at stemming excessive credit growth in some sectors or products and ensuring that banks are very liquid, do have their shortcomings. Loan-to-deposit (LD) ratio is computed as total loans as a ratio of total deposits, while liquidity ratio is prescribed as specified liquid assets as a proportion of deposit liabilities. Currently, the prescribed LD ratio for

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[2] *Countries adopt a suite of supervisory strategies, ranging from single supervisory model, sectoral supervisory model and/or twin peaks supervisory models. These models either confer a collective accountability or single accountability for financial sector institutions each with its benefits and challenges. See Kim (2012)*

[3] *The 2013 UK Legislation also created the Prudential Regulation Authority as a subsidiary of the Bank of England with the responsibility for micro-prudential regulation and the establishment of a Financial Conduct Authority to 'regulate financial firms' conduct and protect consumers.*

deposit money banks is a maximum limit of 80 per cent[4]. Put simply, for every N100 deposit of bank "A", it is permissible for bank "A" to create loans to a maximum of N80 per N100. The counter argument suggests that bank "A" is only liquid to a tune of N20 assuming that (i) it exhausts its lending capacity up to the approved benchmark (ii) there do not exist other non-interest income. Assuming that a depositor requires 100 per cent of his deposit[5], banks become more exposed to higher liquidity risks. Such liquidity challenges, coupled with structural factors, often mean higher interest and in an environment where interest rates are on the average 23 per cent, a puzzling question is; who borrows money at an average of 23 per cent? The emphasis is on the "who". In an economy where over 70 per cent of the country's revenue is derived from oil, the question remains; how much of Nigeria's population are engaged in oil productive activities? Statistics is not readily available. The guess, however, is only a very few are involved. In an attempt to identify the 'who', an analysis of sectoral credit by banks indicates that between 2010 and 2013, an average of 45 per cent of credit were channeled towards the "less preferred sector" with "finance and insurance" and "import and domestic trade" sub-sectors accounting for the larger share. In practice, actual loan-to-deposit ratio have hovered around 40 percentage points below the prescribed target of 80 percent6, leaving banks with more liquidity and more room for credit expansion. Perhaps, this is one factor that has led to the allusions of excess liquidity in the system. For instance, cash reserve ratio (CRR) on public sector deposits was increased in January 2014 from 50 to 75 per cent to stem excess liquidity. Notwithstanding the measures taken, a forward-looking thought process would be to provide answers to questions such as; are there limits of macroprudential policy beyond which they become less effective at stabilizing the financial system?. If such limits do exist, are they easily discernible? At the moment, there are no clear theoretical or empirical answers to some critical macroprudential questions, which this question is one of them.

Most literature argue for the mutual relationship between monetary policy and macroprudential policy. In Nigeria, the monetary policy anchor is the monetary

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4 The 2007 increase in LD ratio to 80 per cent was announced to constrain credit growth. This eroded the excess liquidity which bank faced prior to the global financial crisis largely due to the 2005 mandatary re-capitalization of DMBs.

5 Though the introduction of the 3-tiered KYC requirement which eliminates the requirement for a minimum opening amount on all accounts can encourage this act, it is highly unlikely as this can only happen in a very extreme situation as all depositors would hardly come at the same time to demand 100 per cent of their deposits which often include term deposits and wholesale and retail deposits, (i.e inter-bank takings).

6 As at January 2014, Loan-to-deposit ratio was 54 per cent signaling a buildup in credit creating capacity of banks. It has been suggested that this increase has not been inflationary. This adds momentum to the perception that since these excesses are not chasing 'too few goods', they are being channeled to 'safe havens'- currencies or favourable interest rate on deposits.

policy rate which serves as a signaling guide for other money market rates. Since 2012, the "Monetary Policy Rate (MPR) has been retained at 12.00 per cent with a symmetric corridor of +/- 200 basis points, thus effectively maintaining the SLF and SDF rates at 14.00 and 10.00 per cent, respectively". While the SDF serves one purpose of automatically draining excess liquidity from the system, it also provides a floor for short-term interest rates. A typical scenario is such that Bank "A" sources for funds mainly through deposits. These funds are sourced for a weighted average rate of about 2.5 to 7 per cent say for savings or term deposits, respectively. In other words, for every N100, the "depositor" is compensated with N3 in the case of a savings deposit for parting with his funds and with a maximum LD rate of 80 percent, Bank "A" can either lend to a maximum tune of N80, take advantage of the symmetric interest rate corridor by placing funds at the Central Bank of Nigeria at 10 percent, purchase treasury securities or do both while looking for other investment outlets. An analysis of standing facilities indicates that the deposit component grew by 40 per cent between 2011 and 2012. The design of the rate around a symmetric corridor creates arbitrage opportunities for banks as it encourages placements of deposits at the central bank by banks seeking to advantage of the symmetric nature of the corridor. With an SDF rate of 10 per cent, the incentive for earning risk free interest income is high, thus constraining inter-bank lending and credit creation. This regulatory arbitrage necessitated the increase of CRR on public sector deposits to 75 per cent.

Nevertheless, transactions in the uncollaterized segment of the inter-bank market have been largely minimal or non-existent with the introduction of the symmetric interest rate corridor. Professor Abdul-Ganiyu Garba, a Monetary Policy Committee member captured this succinctly in the MPC communiqué of March, 2014 that, "an SDF rate of 10 per cent has been progressively crowding out the inter-bank market". The counter argument for retaining an SDF of this magnitude has been the likelihood that excess liquidity following a declining adjustment to the SDF would exert undue pressure on the foreign exchange market. Whichever side of the argument one holds sends a signal of the weight attached to these issues, which further reiterates Jácome and Nier (2012) suggestion of the need to ensure an appropriate balance between promoting stability and efficiency of the financial system, with due consideration of the benefits and costs of policy options.

In a bid to minimize systemic risk, regulated financial institutions should be bound by "comply or explain" principle that ensures their compliance or an explanation of their decision not to comply with a regulation. The operational framework of monetary policy will also need to be reconsidered to account for the dynamic

pace of financial market innovations and lessons learnt from the global financial crisis. For instance, the liquidity management framework could be reviewed such that required modifications during normal and crisis times are pre-identified through early warning exercise and other macroprudential tools. The range of financial indicators with possible macroprudential implications should also be broadened. In a review of the publication, 'How might financial market information be used for supervisory purposes?, Omanukwue (2005) stressed the need for central bank supervisors to observe stock market data as a complementary information in surveillance activities. It was not until May 2010 that the central bank introduced a limit on capital market lending to a proportion of banks' balance sheet. Thus, there is an increasing need to integrate features of financial sector distortions not only in existing modeling and forecasting frameworks, but also in the risk-based supervisory frameworks. It, however, remains cogent for supervisors to understand 'if and how market signals can be used' and this border on interpretability and existence of laid down procedures. In addition, in the process of banks' abiding to the principles of pillar 3 of the Basel II accord, there is need to minimize the public stigma often associated with banks' borrowing from the standing lending facilities, especially during crisis times. There is also a growing need to build capacity in the area of macroprudential analysis for the financial system.

The Nigerian financial market is largely dominated by banks. However, in view of the evolving architecture of the Nigerian financial system currently characterized by the growing role of non-bank and non-deposit financial institutions-stock brokerage and pension funds, there is an increasing imperative to coordinate the different regulatory and supervisory activities such that regulatory gaps and leakages are minimized and also to continuously re-examine existing regulatory and supervisory frameworks while taking into account the cost of financial regulation as well as the extent of financial market integration. Furthermore, the design of macroprudential indicators should account for country specific factors.

Some key considerations include developments in the domestic and international capital markets, trends in the capital account of the balance of payments of an economy, structural factors such as the ownership structure, size and exposures of the financial system, which should all feed into macroprudential analysis. The quest for supremacy between monetary and macroprudential policy seems to have resolved itself as the consensus in the literature considers macroprudential policy not as a substitute for monetary policy but a complement. Thus, there should be a policy mix between these two policies and just as monetary policy could be used to minimize financial sector distortions, using macroprudential

instruments to achieve growth and inflation objectives can be costly and inefficient. While the experiences of the 2007 global financial crisis has clearly tilted monetary policy making towards financial stability, maintaining that culture requires painstaking efforts without sacrificing the price stability objective at the altar of financial system stability. Balancing the benefits and costs between financial stability and efficiency remains an art which often requires difficult judgments in policy design and implementation.

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