Macro Prudence vs. Macro Prudential Regulation:

Public Sector Coordination and Intervention for Long Term Financial Stability

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Macro Prudential Supervision vs. Macro Prudence

Macro Prudential Supervision:
Supervisory tools and governance

Macro Prudence:
Public sector working collectively to promote financial system stability
What is financial stability?

- Payment systems work
- Justifiable confidence that “safe” money is safe
- Reasonable access to credit

- Major bank failures inconsistent with financial stability
- Many bank failures, non bank failures also problematic
Cyclical instability is the natural state of the world

• Left to their own devices, banks fail too often
• Ditto markets, economies
• Public sector intervention sometimes helps…
• …and sometimes not
The standard cycle
Phase 1: Confidence grows
The standard cycle
Phase 2: ...leading to a boom
The standard cycle
Phase 3: ...the bust
The standard cycle
Phase 3: V, U, or crash
To compare short term and long term forecasts, we prepare time series testing data (trend with noise) based on formula:

\[ y = 0.2x + \sin(x) + \text{random} \]

Next we apply SSA, ARIMA, GMDH, and cyclic extraction method to training data in interval 0-15. Results are compared with \( y = 0.2x + \sin(x) \).
How should the public sector support financial stability?

- Moderate booms
- Prevent crashes from becoming depressions
- Encourage V shaped rather than U shaped recovery
- Financial sector is an economic shock absorber, not an accelerator
Terms of Trade*

2010/11 average = 100

Index

100
80
60
40
20


* Annual data are used prior to 1960
Sources: ABS; RBA
Macro Prudential Supervision

- Only a sub-set of stability policy
- We already have the tools...
- ...and we already use the tools
The core Agencies

- Treasury/finance ministry
- Central bank
- Market/behaviour regulator(s)
- Prudential regulator(s)
1. Where are we in the financial cycle?

2. Do we need to act?

3. How to coordinate for mutual support?
## Agency roles in Macro Prudence through the economic cycle

<table>
<thead>
<tr>
<th></th>
<th>Normal</th>
<th>Boom</th>
<th>Crisis</th>
<th>Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>APRA</strong></td>
<td>Discipline outliers, ensure sound prudential framework</td>
<td>Active restraint of most aggressive; possibly tighten standards</td>
<td>Advise on which entities are sound and which troubled, estimate losses</td>
<td>Avoid undue conservatism, manage exits</td>
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<tr>
<td><strong>RBA</strong></td>
<td>Analysis, deepen understanding of potential threats</td>
<td>Jawbone to support APRA, maybe monetary policy</td>
<td>Liquidity support, systemic risk estimates</td>
<td>Monetary policy</td>
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<tr>
<td><strong>Treasury</strong></td>
<td>Guard against complacency, advise government, lead on legislation</td>
<td>Support APRA, emphasise the cost of complacency</td>
<td>Advise government on ad hoc responses</td>
<td>Recovery initiatives</td>
</tr>
<tr>
<td><strong>ASIC</strong></td>
<td>Discipline outliers</td>
<td>Proactive enforcement</td>
<td>Protect market operations</td>
<td>Cleanup enforcement</td>
</tr>
<tr>
<td><strong>All Agencies</strong></td>
<td>Building intra-agency cooperation, capacity building, contingency planning</td>
<td>Coordinate anti-boom strategy</td>
<td>Close coordination and crisis response</td>
<td>Learn from experience, adjust statutory framework, encourage recovery</td>
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Hallmarks of public sector success - pushing back the boom

- APRA “most valuable when least valued”
- Treasury and RBA: Support necessary, unpopular APRA decisions
An example: 2002 - 2005 home loans

- Discussion/warnings to Executives and Boards
- Discourage sub-prime lending
- Changed capital, risk weighting standards
- Stress testing
- Supervisory intervention
What about the Crisis? (2008 - 2009)

- **APRA**: Fire fighting, information, problem solving
- **RBA**: Liquidity, Government advice
- **TREASURY**: Government advice
• Recovery to normal

• Strengthen prudential framework

• Continue strong supervision
Who worries about what?
International conformity vs. optimality

- Many Groups writing rules
  - G20
  - BCBS
  - FSB
  - etc

- “Do it our way”

- Australian strategy
  - meet international standards
  - then adjust for Australian conditions
  - “Adjust” = “conservative”
Inter-agency cooperation

- Shared mission
- Minimal overlap/competition
- Maximum cooperation
- Personal relationships help
Where to from here?

- Incremental strengthening of Prudential Framework
- Improve supervision
- Allow for a strong economy...
- ...but protect against a weak economy
- Repeat as necessary over decades
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