MACROPRUDENTIAL POLICY FRAMEWORK

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இலங்கை மத்திய வங்கி
CENTRAL BANK OF SRI LANKA

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Introduction

The Central Bank of Sri Lanka (Central Bank) is entrusted with the responsibility of securing financial system stability, and it is designated as the Macroprudential Authority of Sri Lanka in the Central Bank of Sri Lanka Act, No. 16 of 2023 (the Act), which was enacted in September 2023. The Central Bank's mandate and scope in its role in securing financial system stability is widened by the Act via establishing the Macroprudential Authority. Macroprudential policy measures strengthen the resilience of the financial system by limiting systemic risk, enabling to reduce the likelihood of a financial crisis that could amplify an economic downturn and cause severe welfare losses. The Act formalises the Central Bank's macroprudential approach, which has been in the making during the past with the development of a macroprudential policy framework, establishing a systemic perspective of risk surveillance, initiating dynamic solvency stress testing and liquidity stress testing along with an interconnectedness model, publishing the Financial Stability Review (FSR) and calibrating several macroprudential tools.

As per the Section 63(2) of the Act[1], this document sets out Central Bank's macroprudential policy framework and will be updated from time to time. This document intends to provide the basis for holding the Central Bank accountable for its macroprudential policy decisions, while improving the predictability and transparency of the macroprudential policy making process and contributing to understanding by stakeholders, the role of macroprudential policy in the financial system. Publishing the macroprudential policy framework is a practice followed by many central banks, facilitating a systemic and transparent policy approach.

A transparent and widely understood policy approach is beneficial, as short-run costs of macroprudential policy interventions are much more prominent while their benefits tend to be felt by the stakeholders in the long-run, or they tend to pass by not being noticed at all, though adequate policies are in place. During financial crisis episodes, which occur infrequently, the buildup of large vulnerabilities that lead to financial crises could happen unobserved underneath the surveillance arena. However, once transpire, system-wide crises usually tend to be prolonged and costly.

As such, clear and transparent communication of the macroprudential approach may also improve the effectiveness of macroprudential policies, as it could influence funding and lending strategies and shape the expectations of the actors in the financial system. To that end, this document aims to serve as a guidance note on the Central Bank's role as the macroprudential authority in Sri Lanka and educate stakeholders on macroprudential policy, particularly in terms of its purpose, usage and benefits.

This document explains:

- (i) Objectives/purpose of macroprudential policy
- (ii) Systemic risk surveillance and indicators
- (iii) Macroprudential tools
- (iv) Interactions with other policies of the Central Bank
- (v) Institutional Set-Up
- (vi) Communication of macroprudential stance/systemic risk developments by the Central Bank.

[1] Section 63(2) of the Act states that 'The Central Bank shall develop and periodically update the overall approach to the use of macroprudential tools, and publish such approaches with a view to informing the public of the role of the Central Bank in macroprudential policy'.

Evolution of Macroprudential Policy

a) How have Macroprudential Policies Emerged?

Although many emerging economies have used macroprudential policy tools for some time, macroprudential policies are relatively new, because their importance in safeguarding financial stability was realised widely only post Global Financial Crisis (GFC). The need for an overarching policy framework that focuses on the stability of the financial system as a whole (a macroprudential policy framework) was widely recognised by policymakers as a lesson learned from the GFC.

b) Micro vs. Macro Prudential Policies

"Macro-prudential" refers to an approach to financial regulation that fills the gap between conventional macroeconomic policy and traditional "micro-prudential" regulation of individual financial institutions (Elliott D., 2011). Accordingly, macroprudential policy aims to safeguard financial stability by limiting systemic risk through reducing the likelihood that the financial system amplifies the effects of a severe downturn in the real economy and strengthening the resilience of the financial system. On the other hand, microprudential policies aim to strengthen the resilience of individual financial institutions.

c) Systemic Risk and Macroprudential Policies

Systemic risk is defined as the risk of disruptions to the provision of financial services that is caused by an impairment of all or parts of the financial system and can cause serious negative consequences for the real economy (International Monetary Fund, Financial Stability Board, and Bank for International Settlements, 2009). Macroprudential policies aim to contain systemic risk through two components, i.e., cross-sectional and cyclical. The cross-sectional component focuses on mitigating or developing resistance to the risk of failure that arises from externalities on individual systemically important financial institutions and the systemic risk that arises from the interconnectedness of a financial institution within the financial system. Meanwhile, the cyclical component attempts to mitigate or develop resilience to systemic risk in the time dimension (Adrian, 2017).

Objectives of Macroprudential Policy

Systemic risks and vulnerabilities often surface gradually and unobserved while evolving dynamically. Data pertaining to the financial system may sometimes not directly pinpoint any obvious signs of an adverse development in the financial system. Furthermore, such developments, their causes, and the indicators that highlight them differ from one adverse incident to another, while they evolve frequently. Due to this fluid nature of systemic risk, constant risk assessment, evaluation of the adequacy of macroprudential policy stance, and the ability to respond flexibly are required. As such, macroprudential policy can be regarded as a proactive approach to prudential regulation, through a set of tools and measures that respond flexibly when warranted in a time-varying fashion over the financial cycle.

Such proactive policy measures need to be ready for deployment if and when the authorities identify that prevalent macrofinancial conditions lead to an unsustainable credit or asset price boom, which eventually results in a bust that creates losses for banks, businesses and households, while impeding the smooth flow of funds through the economy. During periods of exuberance, lenders and borrowers tend to engage in excessive risk taking, that results in higher debt levels, worsening a future downturn, and resulting in deep and persistent economic, financial and social consequences.

Thus, the purpose of macroprudential policies is to reduce the likelihood and severity of such serious consequences. The macroprudential policy stance that aggregates the overall macroprudential policy mix tends to tighten in the expansionary phase of the financial cycle as cyclical risks accumulate (Central Bank of Sri Lanka, 2023). The macroprudential policy stance loosens in the recessionary phase of the cycle to create a breathing space for lending institutions and to allow the smooth flow of funds in the economy.

Accordingly, as per the section 63(3) of the Act, in order to achieve the financial stability, the Central Bank shall pursue the following intermediate macroprudential objectives:

a) maintain the resilience of the financial system, in a manner that supports the provision of financial services even under adverse economic and financial conditions.
b) contain risks from unsustainable increases in credit and leverage; and
c) contain risks from interconnectedness within the financial system and control the risk of failure of individual systemically important institutions.

As such, the overarching objective of macroprudential policies is securing financial stability. Section 63(5) states that in the achievement of financial stability, the Central Bank shall consider the interests of depositors.

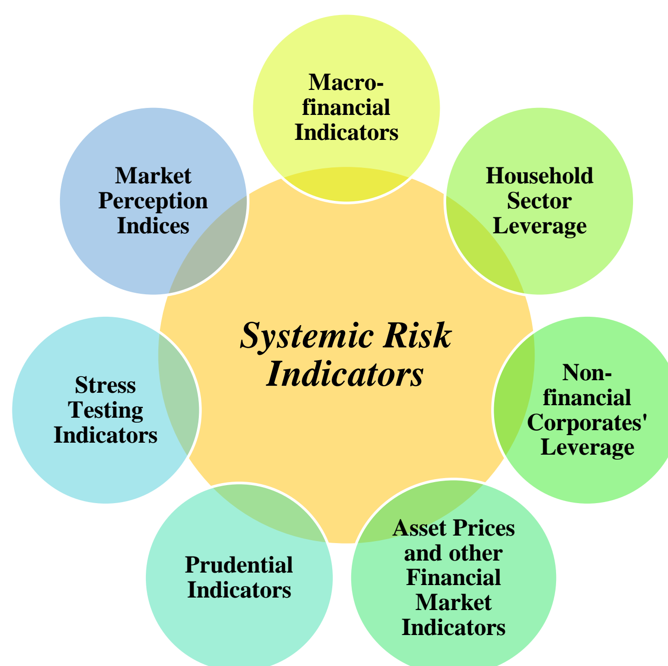
Systemic Risk Surveillance and Indicators

a) Systemic Risk Indicators Used by the Central Bank

Given that macroprudential policies aim to mitigate systemic risk in a forward-looking manner, assessment of systemic risk and determining the appropriate timing, selection and scale of macroprudential policy tools are based on an array of key indicators, supported by expert judgment. This section discusses the range of key systemic risk indicators monitored by the Central Bank for macroprudential purposes. The systemic risk surveillance process evolves and adapts with the developments that transpire in the economy and the financial system, as does the set of indicators.

Financial stability risks can arise from various sources. Key systemic risk indicators used by the Central Bank can be summarised according to the analysis perimeter, keeping in mind that there are interactions between these indicators across categories.

Figure 1: A Snapshot of Systemic Risk Indicators used by the Central Bank



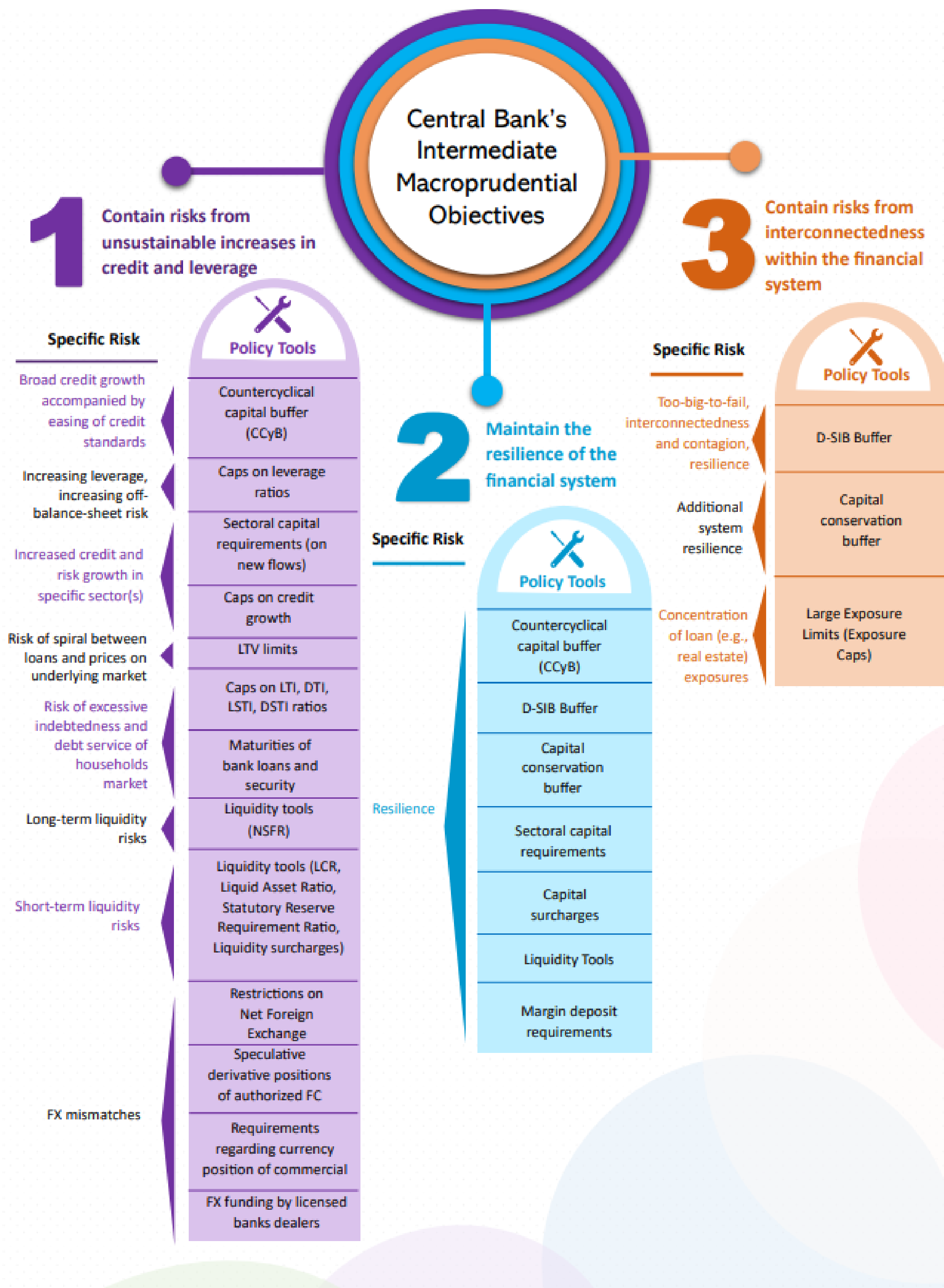
b) The Role of Systemic Risk Surveillance in the Macroprudential Policy Process.

As the name suggests, Systemic Risk Indicators are used to identify systemic risks and vulnerabilities. Such indicators usually point out the status of the financial cycle, the resilience of the financial system and any potential spillovers between the economy and the financial system. Systemic risk indicators, combined with sound judgment and expert discussions, help the Central Bank make prudent assessments of the outlook and effective macroprudential policy decisions.

Macroprudential Tools

International experiences have highlighted that a wide range of flexible, evolving and innovative tools can be used for macroprudential purposes. Macroprudential tools can target various aspects including building capital and liquidity buffers, credit, markets and exposures, to ensure the resilience of the financial system.

Figure 2: Central Bank's Intermediate Macroprudential Objectives mapped with Specific Risks and Applicable Macroprudential Policy Tools



a) Macroprudential Tools Identified in the Central Bank of Sri Lanka Act

Section 66 (1) of the Act identifies a list of fifteen macroprudential tools (instruments) that can be implemented in order to mitigate or eliminate identified systemic risks. These tools can be categorised as Capital Based, Borrower Based, and Liquidity Based depending on the targeted aspect of financial institutions. This list is not exhaustive. The Central Bank can tailor and adopt different tools depending on the circumstances, which is a well-accepted practice observed globally. Figure 2 summarises a set of selected tools that are used globally and can be used for macroprudential purposes. It is pertinent to note that tools which are generally used for other policy purposes such as microprudential, capital flow management and monetary policy, can also be used for macroprudential purposes. Generally, a tool is regarded as a macroprudential tool, when it is used to address a systemic risk.

Due to the fluid nature of systemic risk, the flexibility of tailoring tools in the policy response to address critical systemic risks is an important factor. However, there is a particular set of macroprudential tools that mainly need to be deployed 'ex ante', so that the entities are pre-positioned to address risks that emerge in a timely and effective manner, while allowing space for other policies of the Central Bank to flow through the economy effectively.

b) Central Bank's Macroprudential Tools

In the past, when warranted, the Central Bank had implemented several macroprudential tools. With the enactment of the Act, the macroprudential authority is established and the role of the Central Bank in executing macroprudential tools is expanded. The Central Bank has been working on formalising and calibrating its core macroprudential toolkit with consultations from international experts. The Central Bank will implement appropriate tools when macrofinancial conditions turn suitable for the introduction of such policies, or conditions in the financial system warrant the implementation of such tools in the future.

Other macroprudential tools may be added to the policy toolkit as the financial system and systemic risks associated with the financial system emerge and evolve over time.

Interactions with other Policies of the Central Bank, Spill overs and Limitations

The CB Act recognises Price Stability as the prime objective, while Financial System Stability as the other objective of the Central Bank. Although monetary and macroprudential policies have distinct objectives, they tend to complement or conflict depending on the degree of harmonisation between financial and business cycles. Furthermore, when faced with large economic shocks, authorities' tendency to muster all available policy tools to stabilise the real economy has been observed since the GFC in 2009. This was even more apparent globally during the COVID-19 pandemic, where prudential policies played an important macro-stabilisation role along with more traditional fiscal and monetary policy measures and a vital role in Central Banks' policy mix (Warjiyo and Juhro, 2022).

In a general sense, a stable financial system, which is the objective of macroprudential policy, is required for the effectiveness of monetary policy, as the financial system serves as the transmission channel of monetary policy. On the other hand, financial stability is hard to achieve when prices are unstable and distort the funding and lending process.

When business and financial cycles are synchronised, macroprudential policies tend to complement monetary policy. During the upward phase of the cycle, both inflationary and systemic risks build up. In such conditions, tightening the macroprudential stance to curb credit and asset price growth mitigates the buildup of systemic risk. It will complement monetary policy by curtailing demand pressures in the economy, while reducing the need to raise policy rates. Similarly, monetary policy complements macroprudential policy when policy rates are increased in response to possible overheating of the economy, which elevates exuberance in lending and, hence, systemic risk.

On the other hand, monetary policy may under certain circumstances, contribute to the buildup of imbalances and influence risk taking behaviour of agents. For example, prolonged or swift accommodative monetary policy under certain instances may lead to asset price bubbles and excessive credit growth episodes. Hence, there might be a need for broad based countercyclical macroprudential policy tools or targeted borrower-based tools to address systemic risks. As a stable financial system enables smooth transmission of monetary policy and better allocation of resources in the economy, policy trade-offs need to be considered in such cases.

Borrower based measures such as LTV and DSTI ratios are effective macroprudential tools in addressing risks from unsustainable increases in credit and leverage in targeted sectors. Monetary policy alone may not have adequate space in addressing credit-funded bubbles in certain sectors such as the housing market, as policy rates are broad based and too blunt as tools. In such cases, macroprudential tools enable policy makers to target bubbles, when monetary policy is faced with limited policy space or the unavailability of targeted tools.

Moreover, monetary, macroprudential and microprudential policies complement each other when they use the same information base. A substantial amount of information obtained during monetary policymaking and microprudential supervision is considered in macroprudential policymaking.

It is crucial to understand that macroprudential policies are meant to address systemic risks and to help reduce the likelihood of a system wide crisis, and effects of a severe economic downturn on the financial system. Macroprudential policies cannot address risks pertaining to individual financial institutions and borrowers, and cannot influence underlying non-financial causes of

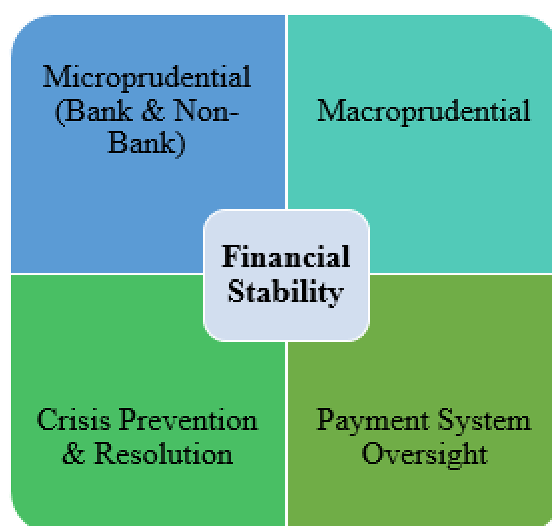
financial cycles such as real estate market supply conditions. Furthermore, even though macroprudential policies can influence economic activity indirectly, policy makers need to be mindful that they are not price stability tools.

This close relationship between policies which involves complementarities, conflicts, limitations and spillovers, predetermines the need to monitor, analyse, and carefully assess the impact of different policies implemented by the Central Bank on the attainment of such policy objectives, when implementing such policies.

Institutional Set-Up

The Act stipulates the broader institutional set-up needed to secure financial stability, with an integrated approach to policy formulation and execution, considering different financial sector participants. The maintenance of financial stability of the Central Bank depends on a sound macroprudential policy framework alongside the microprudential supervision (bank and non-bank), oversight of the payments system and crisis prevention and resolution.

Figure 3: Policies that Target Financial Stability



As the regulator/custodian of financial institutions that comprise approximately 80 per cent of the total asset base of financial institutions in Sri Lanka (as at end 2022), the Central Bank is entrusted with the lead role in operationalising the macroprudential policy framework as the macroprudential authority in Sri Lanka by the Act. The internal coordination in support of the financial stability mandate of the Central Bank is reinforced through the Financial System Stability Committee (FSSC). Policy measures that have a systemic impact are discussed at the FSSC and submitted to the Governing Board (GB). The FSSC consists of key departments that work towards the Central Bank's financial system stability objective. The Macroprudential Surveillance Department (MSD) serves as the secretariat to the FSSC.

The Act recognises the Financial System Oversight Committee (FSOC) as the body that co-ordinates macroprudential policy among financial sector authorities in Sri Lanka and the Ministry of Finance. The objective of the FSOC is to contribute to securing the stability of the financial system in line with the macroprudential policy (Section 71(2) of the Act). The FSOC consists of the Central Bank, Securities and Exchange Commission of Sri Lanka, Insurance Regulatory Commission of Sri Lanka and the Ministry of Finance.

Meanwhile, recognising the existence of interactions between monetary and macroprudential policies, the institutional set-up within the Central Bank is established to facilitate inputs from both policy arenas in the decision making process. Accordingly, the Director of the Economic Research Department is a member of the FSSC to highlight macroeconomic concerns in macroprudential

policy discussions, while the Director of the Macroprudential Surveillance Department is an observer of the Monetary Policy Committee to highlight macrofinancial linkages.

Figure 4 summarises the institutional set-up to operationalise the financial system stability objective of the Central Bank.

Figure 4: Central Bank and the Institutional Set-up of Financial System Stability

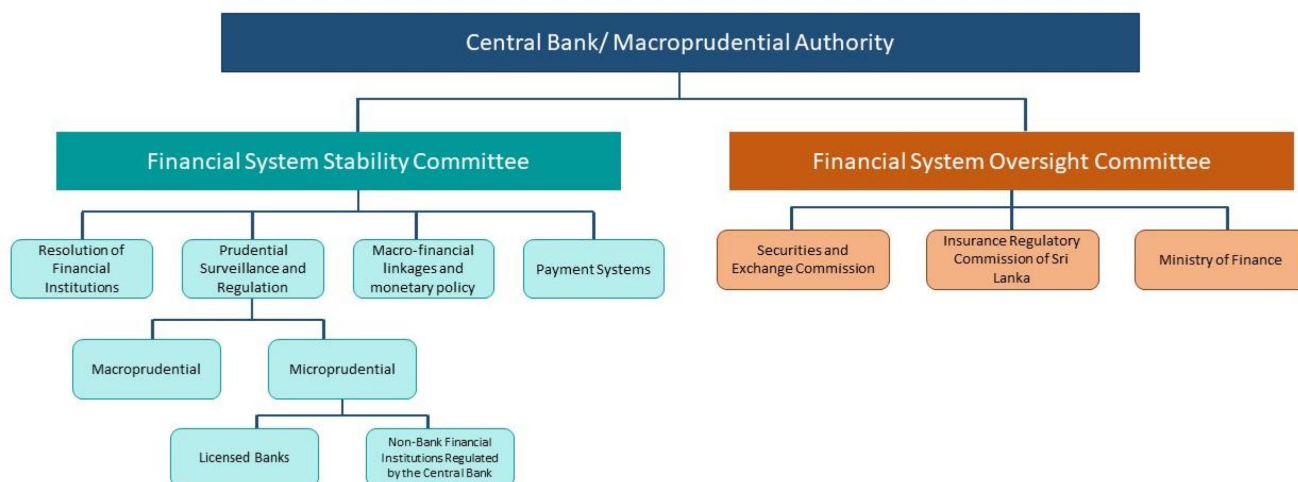
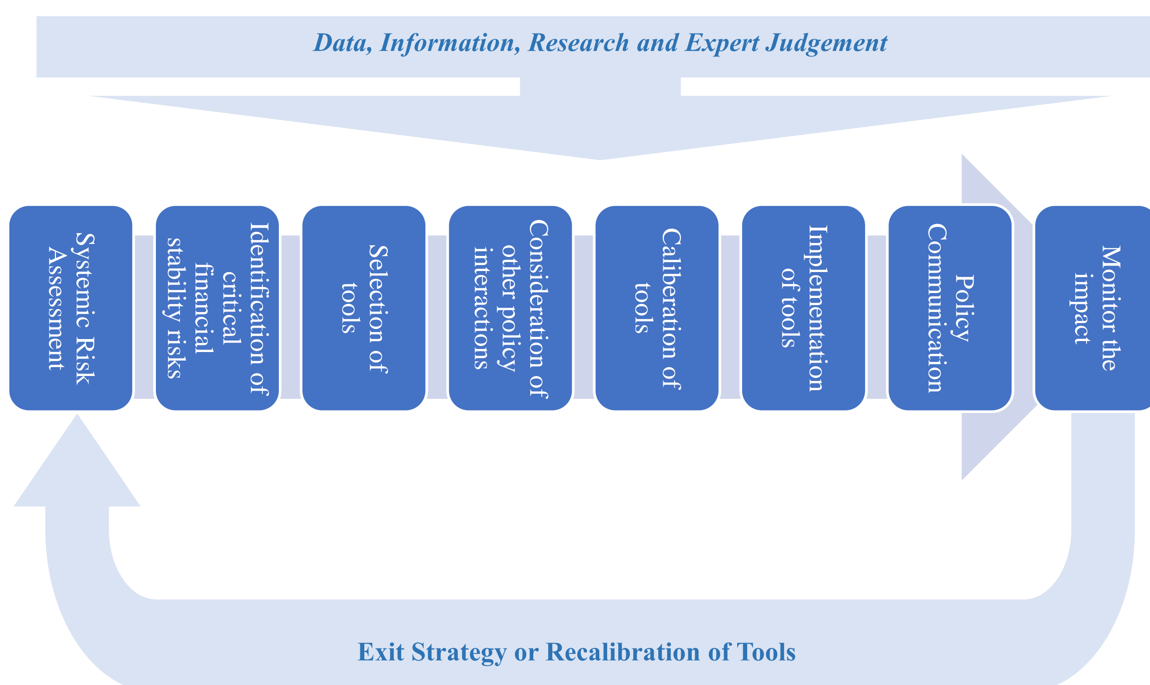


Figure 5: Macroprudential Policy Decision Making Process



Communication of Macroprudential Stance/Systemic Risk Developments by the Central Bank

Communication of financial stability policy and other aspects (such as risk assessments, and data) can help authorities explain to the public the main elements of such policies and changes introduced from time to time.

The Act requires the Central Bank to publish its approach to macroprudential policy and update it periodically (Section 63 (2)) and publish the Financial Stability Review (Section 70).

By clearly communicating financial stability aspects (policy process, risk assessments and data), the Central Bank aims to inform stakeholders of the ongoing developments regarding financial stability policymaking. This improves the transparency of the Central Bank's financial stability policy process and builds stakeholder confidence. Clear communication of financial stability aspects can facilitate market participants to assess market risks with reliable information, which improves understanding of financial sector developments resulting in behavioural changes that support financial stability.

In this background, the Central Bank has already endeavoured to publish data and risk assessments (such as the Financial Stability Review) and will publish statements of policy changes from time to time as and when required.

The Central Bank releases quarterly 'Financial Soundness Indicators' as a key tool for communicating the performance of licensed banks and licensed finance companies supervised by the Central Bank. The publication includes key ratios and financials used in policy analyses to identify strengths and vulnerabilities in the financial system. The publication presents sectoral financial information such as assets, liabilities, earnings, profits and capital whilst providing key ratios associated with each category. This publication is a useful and reliable source of reference for those who are interested in the performance of major financial institutions in Sri Lanka.

The Central Bank has published annual Financial Stability Reviews since 2010. With the enactment of the Act, the publication has become a statutory requirement covering the following aspects:

- the Central Bank's assessment of financial system stability;
- the identification of, and assessment of, the risks and vulnerabilities of the financial system;
- an overview of measures taken by the Central Bank and the other financial sector authorities to identify and manage risks, vulnerabilities or disturbances in the financial system; and
- an overview of recommendations made by the Financial System Oversight Committee during the period under review and the progress made in implementing the recommendations.

The Central Bank will endeavour to improve its frontier of financial stability communication further in the future, learning from domestic and international experience.

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