The Role of Financial Services in Society
Statement in support of macroprudential policies

Prepared in collaboration with Oliver Wyman

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Executive Summary

In 2012, the World Economic Forum, with support from Oliver Wyman, launched a multistakeholder initiative to complement the ongoing regulatory reform process, bringing together a wide range of senior financial stakeholders, including leaders of financial institutions, financial policy-makers, leading economists and academics, executives of commercial firms that rely on financial services and representatives of civil society including consumer advocates and unions. Together, we are seeking a common vision for the industry’s role in society and through that shared vision a strengthened bond between the financial services industry and society at large.

In this document, we express our commitment to ensuring financial stability and our support of the role of macroprudential tools within a holistic approach to financial regulation. We hope this statement underscores the importance of the relationship between financial institutions, policy-makers and society so that we may continue to work together and foster a stable financial future.
In the wake of the financial crisis and the Great Recession, the regulatory debate has focused on reforms that would ensure financial stability, including through the use of macroprudential policies.

One of the key elements of the post-crisis regulatory debate is the emphasis on macroprudential regulation. Macroprudential policies were part of policy-makers’ toolkit in advanced economies before the 1980s and in some emerging markets since the 1990s. It is now often argued that the implementation of macroprudential measures is a source of stability for the financial system.

In the aftermath of the crisis, macroprudential regulation was explicitly included in the mandate of the policy-makers of many advanced economies. Additionally, policy-makers in many jurisdictions have created bodies specifically responsible for ensuring financial stability.

Macroprudential regulation is the use of primarily prudential tools to limit systemic risk and to ensure the right balance between financial stability and economic growth.

Macroprudential policies can be broadly grouped into two categories. Structural policies seek to limit the risk of a financial crisis, and are intended to be in effect at all times. Time-varying tools aim more broadly at “curbing the credit cycle” to constrain excessive credit build-up towards favoured asset classes or more generally at moments of exuberance within business cycles. Application of these tools requires explicit decisions about how and when a policy stance should change, possibly also differentiating such stance across sectors and asset classes.

Because stable credit expansion is required for sustainable growth, macroprudential regulation aims at achieving the right balance between financial stability and economic growth.
We believe that financial stability is a critical public good and benefits all members of society, and that macroprudential regulation is an important mechanism that could contribute to financial stability by reducing the likelihood and impact of future financial crises by ensuring that credit supply is sustainable and not misallocated.

A primary role of the financial services industry is to allocate finance in the real economy to promote economic growth. We believe that the inclusion of macroprudential policies in policy-makers’ toolkit helps to address emerging market inefficiencies in the financial system, such as over-exuberance within asset classes, for example in real estate lending.

Moreover, we believe that a macroprudential perspective is necessary to address systemic risk, as it gives regulators the mandate and responsibility to not only focus on stand-alone regulated entities but also to take a broader perspective on the risks that the financial system is exposed to.

We therefore believe that macroprudential policies should play an important role within financial regulation to help achieve the right balance between financial stability and economic growth.

One of the most significant features of the post crisis retrospective was recognition of the potential role of macroprudential policy in identifying and addressing systemic risk, and providing a coherent framework for the prudential initiatives required to balance financial stability with sustainable economic growth

Douglas Flint, Group Chairman, HSBC

Macroprudential policies could play a critical role in ensuring financial stability in the future, if its governance and potential side effects are managed adequately.

Axel Weber, Chairman, UBS

Macroprudential policies could support financial market stability and thus long-term investors’ ability to provide risk capital to the real economy. Applying a one-size-fits-all approach, however, should be avoided and unintended consequences monitored.

Michel Liès, CEO, Swiss Reinsurance Company
Considerations

It is essential, however, that all stakeholders are aware of the limits of our current knowledge regarding the impact of the application of macroprudential policies, the known and unknown risks that they may generate, as well as the trade-offs that society will be faced with.

It is as yet unclear how effective prudential and monetary tools are at limiting systemic risk and how they may impact the real economy, especially in advanced economies with increasingly complex financial systems. Further research and impact studies on the prudent use of macroprudential tools will be needed to better inform future policy-making.

Governance will be a key success factor for macroprudential regulation. Indeed, if they are incorrectly designed or poorly coordinated, macroprudential measures could be a source of systemic risk. In particular, the institutional set-up needs to strike the right balance between the accountability of policy-makers and their independence with respect to political pressure. As the regulatory framework is increasing the number of tools at its disposal (e.g. macroprudential, microprudential, monetary, conduct, fiscal), coordination between the institutions responsible for each of these tools is becoming critical. Similarly, further international coordination will be needed in order to limit possible spillovers.

In addition, it is important to continue to monitor the possible unintended consequences of these regulations. For instance, applying a one-size-fits-all approach to all players of the financial system may result in increasing pro-cyclicality (for instance, by not distinguishing sufficiently between banks, insurers, cooperative banks, etc.). Similarly, applying macroprudential policies only to regulated entities may limit credit formation and push credit intermediation outside to the shadow banking sector and thus be a source of systemic risk. The application of macroprudential tools to specific sectors and asset classes (e.g. sectoral capital requirements, loan-to-value and debt-to-income caps) may also constrain growth in some sectors and benefit other sectors, thus distorting valuation dynamics that may not be sustainable.

Finally, some of those tools may have societal consequences, and society and policy-makers will face some trade-offs. For example, managing credit supply to real estate is likely to have implications for home ownership and will have different impacts on various segments of society. Similarly, the use of interest rates in the context of financial stability may also have a distributional impact.

Looking Forward

Significant progress has been made to date. Macropurdential policies are still at an early stage and more should be done.

Many countries have included financial stability as part of their policy-makers’ mandate, have created bodies responsible for financial stability and have given those bodies tools to address systemic risks. However, it is important that more research and prudent experimentation be conducted in order to better identify risks, to ensure that the tools used are effective and that they do not generate other risks.

We hope that this statement as well as the Role of Financial Services in Society initiative will contribute to the ongoing dialogue between policy-makers, industry participants, academics and society at large on the right balance between financial stability and economic growth.

The World Economic Forum and the members of the Role of Financial Services in Society initiative are ready to continue working together with the public sector, academia and civil society to make the financial system safer and economic growth more sustainable.
This effort was spearheaded by the World Economic Forum’s Financial Services team and its Industry Partners along with senior leaders in other communities. The development of the publication has been supported by the following project team:

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