MACROPRUDENTIAL POLICY STRATEGY

Financial Stability Department

Bangladesh Bank

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Acronyms

AD	Authorized Dealer
AMC	Asset Management Company
ATDTL	Average Total Demand and Time Liabilities
BB	Bangladesh Bank
BBO	Bangladesh Bank Order
BCA	Bank Company Act
BCBS	Basel Committee on Banking Supervision
BHI	Bank Health Index
BIS	Bank for International Settlements
BSEC	Bangladesh Securities and Exchange Commission
CC	Coordination Council
CCB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CDLC	Central Database for Large Credit
CRAR	Capital to Risk-weighted Asset Ratio
CRE	Commercial Real Estate
CRR	Cash Reserve Requirement
D-SIBs	Domestic Systemically Important Banks
DBR	Debt Burden Ratio
DTI	Debt-to-Income Ratio
DSTI	DebtService-to-Income
EU	European Union
FC	Finance Company
FSC	Financial Stability Committee
FSD	Financial Stability Department
FSR	Financial Stability Report
FX	Foreign Exchange
GFC	Global Financial Crisis
HQLA	High-Quality Liquid Assets
IDRA	Insurance Development and Regulatory Authority
IMF	International Monetary Fund
ITM	Interbank Transaction Matrix
LCR	Liquidity Coverage Ratio
LTV	Loan-to-Value Ratio
MRA	Microcredit Regulatory Authority
m-o-m	month-over-month
NSFR	Net Stable Funding Ratio
NPL	Non-performing Loan
NAV	Net Asset Value
QFSAR	Quarterly Financial Stability Assessment Report
RWA	Risk-Weighted Asset
SAARC	South Asian Association of Regional Co-operation
SLR	Statutory Liquidity Requirement
SRCM	Systemic Risk Crisis Management
USA	United States of America
USD	United States Dollar
Y-O-Y	Year-Over-Year

Part A

Theoretical Aspects of Macroprudential Policy

1. Introduction

Before the Global Financial Crisis (GFC), financial stability efforts were largely centered on microprudential approaches, focusing on the soundness and vulnerabilities of individual institution rather than broader systemic risks. Supervisory policies primarily aimed at mitigating the risk of failures of individual institution, largely ignoring their potential systemic implications on the broader financial system and the overall economy. However, the collapse of Lehman Brothers in the USA during the GFC prompted the policy makers to consider the systemic dimension of financial stability that was previously neglected. This pivotal event highlighted the interconnectedness of financial institutions and the critical importance of considering macroprudential factors in regulatory frameworks.

In the aftermath of the GFC, policymakers as well as academicians have become intensely aware of the necessity for robust financial regulation and supervision ensuring overall stability of the financial system. Taking into cognizance the severe macroeconomic consequences of financial instability, regulators have shifted their focus towards promoting financial stability and addressing systemic risks. International institutions such as the Basel Committee on Banking Supervision (BCBS), the Bank for International Settlements (BIS), the European Systemic Risk Board, and the Financial Stability Oversight Council in the USA have emerged as key players in advocating for and implementing effective macroprudential policies. Their efforts underscore the imperative of designing regulatory frameworks that not only safeguard against individual institution failures but also mitigate financial imbalances that could potentially trigger broader systemic crises. Such emphasis on macroprudential policy area represents a paradigm shift towards a more comprehensive regulatory approach to ensure stability and resilience of the global and local financial system.

2.Definition of Macroprudential Policy

Macroprudential policy refers to a set of regulatory measures aimed at promoting the soundness and stability of the overall financial system and payment mechanisms. It focuses on addressing systemic risks that could potentially disrupt the functioning of the financial system.

Macroprudential policy is generally understood as the use of prudential measures to limit systemic risk. These measures are designed to mitigate the incidence and severity of financial crises by identifying and addressing vulnerabilities within the financial system.

3.Objectives of Macroprudential Policy

Macroprudential policy aims to preemptively address vulnerabilities and strengthen the resilience of the financial system to mitigate the impact of potential crises, although it does not explicitly encompass crisis management as a function.

Based on numerous literatures, the fundamental objective of macroprudential policy is to lessen or minimize the extreme systemic financial risks arising from both domestic and external shocks. This implies that it should strive to prevent severe financial crises and reduce their effects on the real economy if they nevertheless arise. The objectives of macroprudential policy can be set at three levels: (i) the overall objectives that provide the overall goals of policymakers, (ii) the intermediate objectives that are likely to be partial aspects of the ultimate objective; and (iii) the operational objectives that are very closely linked to individual policy instruments.

3.1 Overall Objectives

The overall objective of macroprudential policy is financial stability i.e to build resilience of financial institutions, markets and infrastructures. However, sometimes multiple objectives can arise when macroprudential responsibilities are handed over to the central bank that is entrusted with formulating and implementing monetary policy with objectives such as price stability, exchange rate stability, and maximum employment, or to regulators with microprudential or consumer protection responsibilities.

3.2 Intermediate Objectives

Intermediate objectives focus only on financial stability, keeping minor focus on other overall objectives of the macroprudential authority. Basic intermediate objectives are:

a. Counteracting excessive credit growth.
b. Managing liquidity risks.
c. Limiting excessive concentration.
d. Limiting the misaligned incentives that mitigate systemic risks.
e. Strengthening the resilience of financial infrastructures.

3.3 OperationalObjectives

Operational objectives are set to facilitate the calibration and assessment of macroprudential policy actions. The common operational objective is compliance with the instrument setting.

4. Scope and Need for Macroprudential Policy to deal with Systemic Risk Dimensions

Macroprudential policy encompasses a wide range of financial institutions, including banks, finance companies, insurance companies, microfinance institutions, capital markets, payment systems, and market infrastructures and all other important market players. However, since banks are the primary credit providers, macroprudential efforts tend to focus on the banking sector. Policymakers must also monitor systemic risks beyond financial institutions and implement policies to contain them effectively.The requirement for macroprudential policies arises from two systemic risk dimensions namely time and cross-sectional dimensions.

The time dimension focuses on managing financial booms and busts that result from both demand-supply dynamics and the behavior of financial intermediaries. On the contrary, the cross-sectional dimension addresses the interconnectedness and risks shared across financial institutions or sectors.

Macroprudential policy tools are deployed based on these dimensions, aligning with the intermediate objectives of supervision to mitigate risks and enhance resilience throughout the financial system. The systemic risk events and prescribed macroprudential policy tools are delineated in Table 1.

Table 1: Systemic Risk Events and widely used Macroprudential Policy Tools

Systemic Risk Events	Widely used Macroprudential Policy Tools
Excessive credit growth	Credit growth cap, countercyclical capital buffer, raising risk weights for credit exposures in the targeted sectors/areas, limits for debt-to-income ratio, debt-service-to-income ratio, loan-to-value ratio.
Leverage risks	Limits on the leverage ratios, provisioning, margin/haircut limit, maturity cap.
Liquidity risks	Calibrating short-term and long-term liquidity requirements, foreign exchange lending restriction, currency mismatch limit, open foreign exchange position limit, valuation rules in case of lending contracts.
Higher concentration of exposures	Systemic risk buffer, cap on large exposures.
Misaligned incentives of financial institutions or their clients that increase systemic risks	Buffer for D-SIBs, systemic risk buffer, increasing the fund requirements of entities, restrictions on dividend.
Insufficient resilience of financial infrastructure	Assessing risk management across payment systems and key financial infrastructure entities.
Interconnectedness	Imposing concentration limits on balance sheet items, systemic capital surcharge, subsidiarization, regulation of central counterparties (CCP).

5. Macroprudential Communication

Effective macroprudential communication is essential for promoting financial stability and requires tailored strategies to engage diverse stakeholders, navigate market conditions, and address systemic risks proactively and transparently.They help to shape the expectations of target audiences, promote the comprehension of systemic risks by the public, and facilitate awareness of macroprudential regulation.

In essence, communicating macroprudential policy presents challenges, especially in both stable and stressed market conditions. Periodic engagement can enhance transparency and reduce the shock value of interventions when needed.

During stressed conditions, effective communication becomes even more critical, focusing on clarifying risks, the economic outlook, and the measures taken by financial authorities to manage uncertainties.

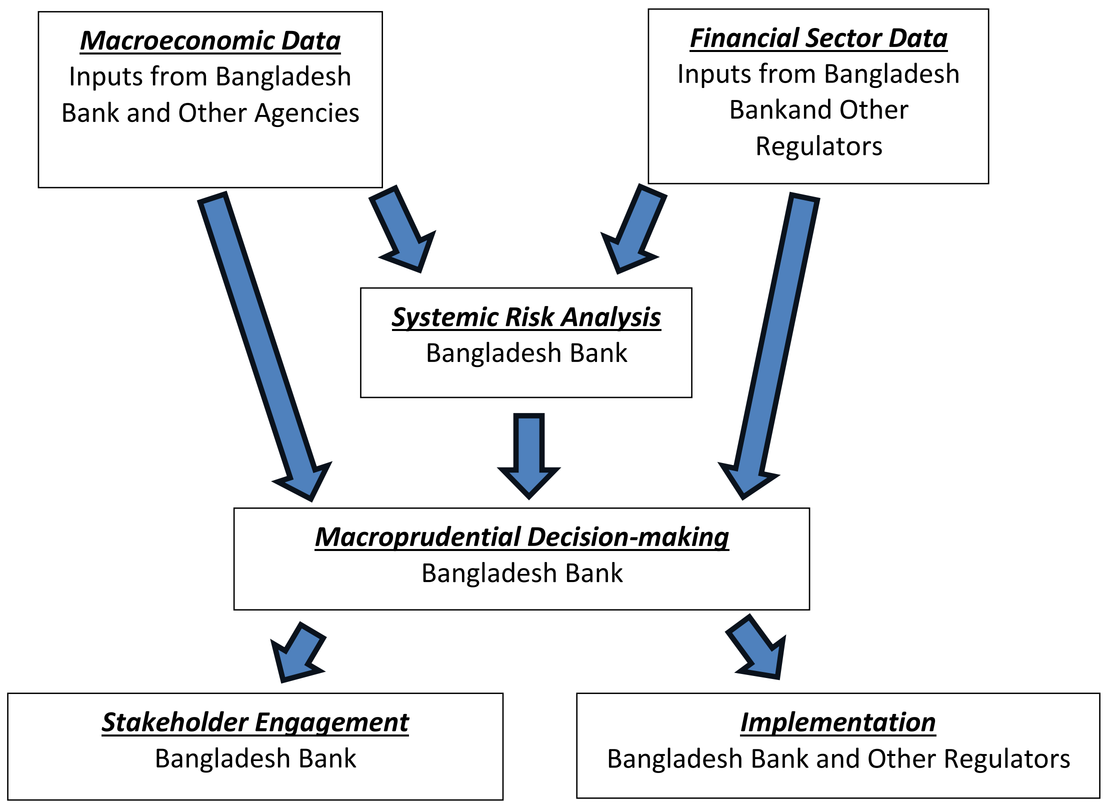
Bangladesh Bank regularly publish various reports like financial stability report (FSR), quarterly financial stability assessment report (QFSAR), Bangladesh systemic risk dashboard (BSRD), monetary policy statements (MPS) to convey systemic risks of financial system for diversified stakeholders.

6. Institutional Arrangements and Legal Mandate

Macroprudential policy mandate considerably differs across countries. The legal and institutional setup is highly relevant in exercising mandates by the authorities. The choice, calibration, and timing of macroprudential policy tools depend on how authorities assess vulnerabilities and their confidence in their analysis. However, in most of the jurisdictions, the macroprudential policy mandate is shared among several public agencies including the central bank. In Bangladesh, the responsibility for ensuring financial stability rests mainly with Bangladesh Bank. The Bangladesh Bank Order, 1972, the Bank Company Act, 1991 and the Finance Company act, 2023 empower Bangladesh Bank to formulate necessary prudential policies and regulations. Bangladesh Bank has established a coordinated supervision framework called the Coordination Council (CC), chaired by the Governor of Bangladesh Bank, which holds regular meetings with other regulators to review macroprudential oversights and financial sector goals and vulnerabilities. A Financial Stability Committee (FSC) could establish a structured approach to coordinate macroprudential policy strategies and oversee the strategic implementation of related decisions, serving primarily in an advisory capacity.

Regardless of where the mandate lies, coordinating macroprudential policy poses inevitable challenges, including sharing information, assessing risks, determining intervention timing, and ensuring consistent stakeholder engagements. These issues may become even more complex as Bangladesh Bank often cannot manage the entire macroprudential decision-making process alone as comprehensive data and specialized expertise needed for comprehensive macro-financial analysis. Therefore, collaboration with other agencies is essential throughout the macroprudential decision-making process, as shown in Figure 1.

Figure 1:The Macroprudential Decision Process



7. Issues involved in operating macroprudential policies and instruments

In Bangladesh, understanding the interactions within the financial system and macroprudential policies remains limited due to mainly inadequate access to relevant data, scarce policy research and low awareness of the macro-financial impacts of these policies. Analyzing how macroprudential interventions affect financial stability provides essential insights into systemic vulnerabilities. For this, policymakers require skilled manpower and diverse macroprudential tools, customized to measure systemic impacts across financial sectors effectively.

To manage emerging financial imbalances distinct from normal cyclical patterns, both aggregate and sector-specific indicators, such as leverage, credit growth, and liquidity mismatches should be monitored. Given that risks don't develop evenly across sectors, tailored responses, like targeted stress tests, calibration of macroprudential policy tools and supervisory guidance, help maintain balanced policy application. With an evolving financial system, flexibility in macroprudential policy responses remains crucial, although an indicator-based transparent macroprudential policy strategy can improve predictability of plausible systemic imbalances and vulnerabilities.

Macroprudential policymakers must also consider cross-border effects and innovation impacts in financial markets, as macroprudential and monetary policies should ideally work in tandem, though neither can fully counteract the economic cycle. Recognizing that macroprudential policy is an inexact science, some ambiguity in its application is unavoidable. Since financial stability cannot be precisely measured, unlike inflation or output concerns in monetary policy, it's crucial to adopt a proactive approach throughout the financial and economic cycle.

Part B

Macroprudential Policy Tools/InstrumentsUsed in Bangladesh

To design and implement a suitable macroprudential framework and to contribute to financial stability of Bangladesh, Bangladesh Bank has established Financial Stability Department (FSD) in May, 2012. A lot of macroprudential instruments that have already been adopted by Bangladesh Bank are furnished in Table-2.

Table 2: Macroprudential framework and tools used in Bangladesh

SL	Sector	Category	Tools
I.	Banking Sector	Counter-cyclical capital buffer	Counter-cyclical capital buffer framework was approved on April 21, 2014 in line with Basel III guidance.
		Capital conservation buffer	Capital conservation buffer (CCB) framework in line with Basel III was announced in December 21, 2014.
		Limit on leverage ratio	From January 1, 2015, banks are required to maintain minimum leverage ratio on both solo and consolidated basis.
		Limit on distributions	All schedule banks are allowed to distribute dividend against share capital according to their maintained Capital to Risk-weighted Ratio (CRAR).
II.	Household Sector	Cap on credit growth to the household sector	Cap on credit growth had imposed for unsecured loan, credit cards etc.
		Loan restrictions or borrower eligibility criteria	Cap on loan-to-value ratio has been adopted for housing finance, Auto loans, Digital device loans and other consumer financing like credit card and personal loans.
			Cap on debtservice-to-income ratio, limit on amortization periods has been adopted for auto loans, consumer durables/professional loans, unsecured personal loans.
			Limit on lending and borrowing denominated in foreign currency: Banks cannot disburse any loan or overdraft in foreign currencies without prior approval of BB.
III.	Corporate Sector Tools	Corporate sector capital requirements	Banks' exposures to the corporate sector (excluding equity exposures) are subject to risk weights which were fixed vide BRPD Circular No. 09/2008 "Risk-Based Capital adequacy (RBCA) for Banks" (revised regulatory capital framework in line with Basel III).
		Loan restrictions or borrower eligibility criteria	Limit on lending and borrowing denominated in foreign currency:Offshore Banking Units (OBU) of local banks can lend foreign currency denominated loans to individual corporate borrowers after taking permission from BB.
		Exposure caps on corporate credit in foreign currency	Foreign-currency-denominated loans: Resident corporates have to take permission from Bangladesh Investment Development Authority (BIDA) and BB. Exposure caps on External Term Borrowing: For availing long/mid-term loan from Offshore Banking Unit, resident/nonresident entities need to obtain approval from BB.

		Other measures to mitigate systemic risks from loans to the corporate sector	BB has developed a Central Database for Large Credit (CDLC) to monitor the large exposures of banks and other FIs in a more structured way as announced and effective on December 24, 2015.
IV.	Liquidity Tools Applied to the Banking Sector	Liquidity buffer requirements	The Liquidity Coverage Ratio (LCR) requirement was announced and effective in2015,based on Basel III framework, with slight customization from Bangladesh context.
		Stable funding requirements	Net Stable Funding Ratio (NSFR) requirement was announced and effective in 2015, in line with Basel III framework.
		Loan-to-Deposit (LTD)ratio	This ratio was announced as ADR (Advance to deposit ratio) and effective in 2016, using the formula "100%-CRR-SLR".
		Limits on maturity mismatches	The upper limit on maturity mismatches for cash outflow in one-month time bucket was 16.5%.
		Wholesale borrowing limits	For a primary dealer bank (dealer of government securities), wholesale borrowing should not exceed 100% of eligible capital; for the other banks, the limit should not exceed 80% of eligible capital.
		Highest acceptable limit for commitments	The highest acceptable limit for commitments is the lowest amount of the following three benchmarks: (a) 50% of total assets; (b) 500% of total eligible capital; (c) 250% of HQLA.
		Reserve requirements for macroprudential purposes	The requirements of CRR and SLR for banks are determined against average total demand and time liabilities (ATDTL) held by the bank. These ratios are calibrated by the BB as macroprudential tool in addition to using as those monetary policy tool.
		Limits on foreign exchange open positions	This tool was announced and effective in 2016. Banks are required to limit net foreign exchange positions up to 20% of the total eligible capitals, which is comprised of the sum of Tier 1 eligible capital and Tier 2 eligible capital.
		Foreign exchange swaps or derivative positions	Banks may undertake swap transactions in line with their counterparty limit in accordance with the core risk management guidelines issued by BB.
		Constraints on foreign exchange funding	Banks may obtain short-term loans and overdrafts for a period not exceeding seven days at a time from overseas branches and correspondents at Secured Overnight Financing Rate (SOFR)+3.50 percent to fulfill trade finance need in foreign exchange. Banks may use up to 50% of Nonresident Foreign Currency Deposit (NFCD) balances for making loans to exporters and to discount usance bills.
V.	Tools to Address Systemic Liquidity Risk and Fire Sale Risk in the Nonbank Sector	Securities lending market	As announced and effective January 1, 1999, securities transactions made by deposit-taking corporations are subject to margins/haircuts regulation. Different levels of margins/haircuts are applied to different types of collateralized assets. These rules apply to retail loans provided by banks.

VI.	Tools to Address Risks from Systemically Important Institutions and Interconnectedness within the Financial System	Measures to mitigate risks from interconnectedness	Limits on the size of exposures between financial institutions: Under Sections–26(Kha) and 45 of the BCA, 1991, BB sets certain limits on the size of exposures to a single person, counterparty, or a group based on bank's eligible capital.
VII.	Tools to Address Other Sources of Systemic Risks	Measures to mitigate risks from financial institutions' exposures to sovereigns	For risk weighting claims on Government, Central banks and other Sovereigns, banks may use the rating and risk weight as recognized by their supervisors (if any) or risk scores published by the consensus risk scores of export credit agencies (ECAs) participating in the "Arrangement on Officially Supported Export Credits."
		Measures to address risks from financial institutions' cross border exposures (including reciprocity)	In respect of any country, where a bank's net funded exposure is 2% or more of its total assets, the bank is required to make provision for dealing with that country risk exposure. However, exposures of foreign banks at their home country were excluded.
		Measures to mitigate risks from financial institutions' exposures to crypto assets	Business related to virtual asset, virtual currency/crypto currency and their exchange/transfer/trading is prohibited in Bangladesh to date.

Part C

Macroprudential tools that could be applied in Bangladesh

To harness the precise advantages of macroprudential policies in managing financial cycles, Bangladesh Bank (BB) has already adopted several macroprudential tools. However, there is room for resorting to some other tools as detailed below to bolster the stability of the financial system against macro-financial shocks.

I)Banking Sector

Forward-looking or dynamic loan loss provisioning requirements could be introduced by BB within the banking sector's macroprudential tools, particularly aimed at determining general loan loss provisions for performing loans aligned with probability of default (PD), rather than specific provisions for incurred losses. This approach aims to create a reserve, known as a "dynamic loan loss reserve” during boom periods to cover future realized losses during economic downturns. By addressing disincentives for robust provisioning within the regulatory capital framework, this initiative will also help improving transparency by encouraging banks to align their provisioning practices with accounting standards such as IAS 39 or IFRS 9, focusing on expected loss approaches.

II) Household Sector

Given that the manifestation of systemic risk varies depending on country-specific circumstances, additional measures such as household (mortgage) loan growth rate (m-o-m and y-o-y); share of household (mortgage) loans to total credit; and share of banks and FCs household loans (changes of the share over time) could be developed to further bolster resilience of household sector.

III) Corporate sector

To address systemic risks arising from vigorous corporate credit growth, corporate credit within total credit, alongside its growth rate could be monitored. The share of commercial real estate (CRE) loans in total credit, and deviations from their trend could also be monitored. Moreover, to tackle foreign exchange (FX) risks originating from the corporate sector, tracking the growth rate of FX corporate credit, and monitoring the FX corporate credit gap (defined as the difference between FX corporate credit and its trend), as potential indicators of excessive FX lending could be monitored.

IV) Liquidity Tools

Additional liquidity tools like liquid asset ratio, core funding ratio, levies on noncore funding, and constraints on foreign exchange funding could be introduced to reduce systemic liquidity risks in the financial system by enhancing its stability over time.

V) Tools to Address Systemic Liquidity Risk and Fire Sale Risk in the Non-bank Sector

Regulatory body may concern with liquidity management responsibility and accountability of asset management companies (AMCs) which operate mutual funds mostly and insurance companies to manage systemic liquidity risks, and application of appropriate liquidity management tools. To address systemic liquidity risk from AMCs, tools like liquid buffer requirements (e.g. maintain highly liquid assets of at least 10% of NAV), limits on leverage, investment limit regulation can be used. Besides, paid-up capital requirement, and maintaining a surplus of assets over its liabilities of an amount not less than a specified margin of solvency, specified risk weight to non-liquid asset, exposure limit for sector, group, and individual entity can be applied to mitigate systemic liquidity risk for insurance companies.

VI) Tools to Address Risks from Systemically Important Institutions andInterconnectedness within the Financial System

Capital and liquidity surcharges on systemically important institutions, higher loss absorbency requirements, additional risk weights on exposures between financial institutions, quantitative limits on such exposures relative to capital can be applied to systemically important entities. Moreover, systemic banks could often face stricter leverage ratio requirements, such as a buffer of two percentage points above the minimum, to address structural systemic risks effectively.

Part D

Way Forward

The Bangladesh Bank Order, 1972, the Bank Company Act, 1991 and the Finance Company act, 2023 empower Bangladesh Bank to formulate necessary micro and macro prudential policies and regulations for banking and finance companies' sectors of the financial system in Bangladesh. However, macroprudential policies may not prevent the future financial crises rather can alleviate the probability and depth of such events. This report delineates BB's thinking for executing the financial stability agenda and the tools currently being used to conduct market surveillance and then apply various macroprudential policy interventions to specifically manage systemic risks. The objectives of macroprudential policy strategy to ensure financial stability, is crucial to protect financial market failures due to interconnectedness, contagion effects, complementarities, and correlation where the ultimate goal is sustainable economic growth. To meet the challenges of systemic risk management and introducing calibrated macroprudential policy tools, systemic risk preparedness has to be pre-emptive, which requires considering spillover concerns even before conventional market indicators signal obvious outright disturbances.

To communicate the state of systemic risks from various financial sectors, Bangladesh Bank has been publishing a risk dashboard titled Bangladesh Systemic Risk Dashboard. Besides, BB has developed 'Central Database for Large Credit (CDLC)' for monitoring the large loans of banks and finance companies, and 'Interbank Transaction Matrix (ITM)' for measuring the positions and sources of liquidity along with interconnectedness. A coordination council (CC) has also been formed for tackling the sources of systemic risks. As macroprudential policies may overlap with monetary policy and banking supervision, incidents of policy conflicts may also arise. By having an open discussion among all regulatory/supervisory authorities, the macroprudential policies strategies can become effective and orchestrate better macro-financial future. Nevertheless, Bangladesh Bank needs to initiate a further range of macroprudential policy tools considering heterogeneous risk behaviors of stakeholders that change with different market conditionsacross time.

Glossary

Financial stability – refers to the state of the financial system in which it can properly perform its main functions, such as financial intermediation and making payments, as well as being able to withstand crises. The financial system is considered stable if a) it effectively redistributes resources from savers to investors, b) financial risks are thoroughly evaluated and properly managed, and c) it can absorb shocks without significant negative consequences.

Systemic risk – is the possibility of a functional failure of the financial system, in whole or in part, that will disrupt the proper redistribution of financial resources and potentially produce adverse effects for the entire economy. Systemic risk has a cyclical and a structural component.

Cyclical risks – are related to the tendency of economic agents to take excessive risks during economic upturns.

Structural risks – are driven by the distribution of risks and interconnectedness between participants in the financial system. Structural risks make the system vulnerable.

Macroprudential policy – encompasses a set of measures aimed at identifying, evaluating, and mitigating systemic risks.

Macroprudential policy instruments – are requirements and restrictions imposed on the financial system or on individual groups/market participants aimed at achieving the strategic and intermediate objectives of macroprudential policy.

Capital buffer – is the amount of capital a financial institution must hold above the required regulatory minimum. It either can be set as a single rate for all financial institutions (or groups of financial institutions) or individually for a bank based on an assessment of risk.

Systemically important financial institutions – are those financial institutions whose failure could lead to material imbalances in the financial system and the economy, due to their size, complexity, indispensability, and interconnectedness with other institutions.

Stress testing – is a diagnostic instrument for evaluating the resilience of financial institutions and/or the financial system to potential shocks, such as abrupt changes in the domestic or external economic environment, or in the behavior of economic agents.

Regulatory arbitrage – is a practice by which financial institutions take advantage of softer regulations to boost profits, which can result in a build-up of systemic risks.

SREP (supervisory review and evaluation process) – is a supervisory evaluation process in which a bank's risks are assessed in terms of the bank's business model, corporate governance, capital adequacy, and liquidity. The probability of default (PD) ratio shows the likelihood that a borrower/counterparty will be unable to repay debt (default).

Corporate Sector-That part of the economy which is conducted by companies working for private profit.

Household Sector-The household sector is an institutional sector in national accounts encompassing all households. Institutional sectors within national accounts bring together economic units with broadly similar characteristics and behaviour.

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