



CENTRAL BANK
OF THE REPUBLIC OF AZERBAIJAN

BANKING SECTOR MACROPRUDENTIAL POLICY FRAMEWORK

December 2024

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Glossary of terms

<u>Macroprudential policy</u>	the policy pursued to mitigate systemic risks, enhance financial system resilience against shocks that could potentially impact the national economy, and thus maintain financial stability
<u>Financial stability</u>	the state where the financial system can effectively perform its core functions while also withstanding crises
<u>Macroprudential tools</u>	a set of capital, liquidity, and borrower-based tools used to achieve ultimate and intermediate objectives of the macroprudential policy
<u>Systemic risk</u>	the risk of a financial crisis arising in the financial system as a result of problems accumulating in one or more segments of the financial system and spreading in a chain reaction
<u>Cyclic systemic risk metrics</u>	sensitivity of the behavior of financial institutions to changes in the financial cycle
<u>Structural metrics of the systemic risk</u>	sensitivity arising from the diversification of financial institutions' activities and their interconnections
<u>Systemically important bank</u>	financial institutions that, due to their significant role in the financial system and connections with other financial institutions, can pose a threat to the stability of the financial system and the overall economy when faced with financial difficulties
<u>Stress-testing</u>	a tool used to assess the resilience of financial institutions to various economic and financial shocks
<u>Network model</u>	a modeling tool that allows the assessment of the impact of a hypothetical default of any financial institution on the overall financial system and individually on other institutions
<u>Regulatory arbitrage</u>	

	the accumulation of systemic risks resulting from financial institutions engaging in risky activities by exploiting differences or gaps in regulatory frameworks
<u>Idiosyncratic risk</u>	a specific risk arising from the activities of a financial institution
<u>Interest rate risk in a banking book</u>	the current or prospective risk to the bank's capital and earnings arising from adverse movements in interest rates that affect the bank's non-traded balance sheet and off-balance-sheet positions
<u>Credit concentration risk</u>	the risk arising from the concentration in a financial institution's credit portfolio due to a specific borrower, segment, geographic region, or asset class
<u>Counterparty credit risk</u>	the risk arising from inability of financial institution's counterparties to meet their financial liabilities

Introduction

With the amendment made to the Law of the Republic of Azerbaijan ‘on the Central Bank of the Republic of Azerbaijan’ in 2022, the Central Bank of the Republic of Azerbaijan (hereinafter – the CBA) is mandated to safeguard financial stability within the authorities specified in the laws regulating financial markets. Hence, the CBA discharges the functions of maintaining the stability and sustainability of financial markets, regulating, and supervising financial markets, and exercising macroprudential regulation and supervision.

This framework document reflects the ultimate and intermediate objectives, application directions, and process of the macroprudential policy implemented by the CBA, its institutional design, communication, policy approach regarding the non-bank sector, as well as the interaction of macroprudential policy with other policies. The paper also presents the types of macroprudential tools used by the CBA to promote financial stability and those that may be used in the future, in the context of the improvement of the regulatory framework.

The Monetary Policy and Financial Stability Committee discussed and approved the ‘Banking sector macroprudential policy framework’ document on 4 December 2024 for public disclosure (Protocol Decision No. 12).

1. Fundamentals of the macroprudential policy

1.1. Importance of the macroprudential policy for financial stability

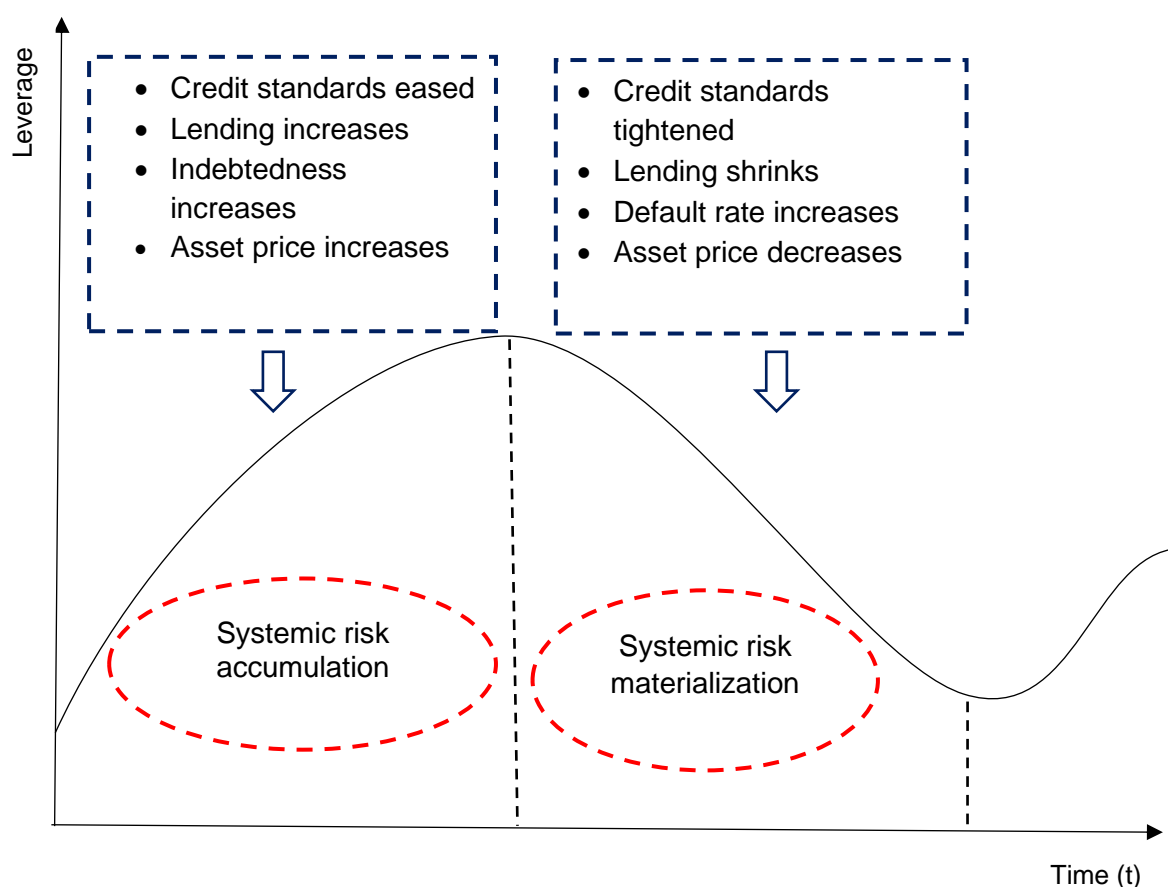
As a relatively new approach **macroprudential policy** emerged in response to the global financial crisis of 2008-2009. Individual micro prudential supervision of financial institutions was not sufficient to ensure the stability of the overall financial system, and there was a need to address the limitations of traditional micro prudential oversight. In this context, the implementation of macroprudential supervision and regulation became crucial for managing systemic risks and ensuring overall financial stability. The **goal of macroprudential policy** is to enhance the resilience of the financial system, safeguard financial stability by eliminating the accumulation of systemic risks, and thereby support long-term sustainable economic growth. **Financial stability** is defined as the condition in which the financial system is capable to perform its core functions effectively while also being resilient to crises. Financial stability is a key pre-requisite for achieving long-term economic growth in the real economy. Financial stability supports long-term economic growth by ensuring the continuous and reliable operation of the financial system and infrastructure, enhancing resilience to external shocks, and creating a preventive buffer against financial crises. The primary threat to financial stability is the likelihood of systemic risks occurring. The **systemic risk** arises when problems in the operations of one or more segments of the financial system spread in a chain reaction to other components, leading to a financial crisis and causing severe economic consequences. The systemic risk emerges from cyclical and structural vulnerabilities.

Cyclical sensitivity refers to the tendency of financial institutions to take on excessive risks during the expansion phase of the financial cycle and adopt an overly conservative approach during the contraction phase. Cyclical sensitivity leads to the accumulation of risks over time, which can ultimately pose a threat to financial stability (Chart 1).

Structural sensitivity refers to vulnerabilities arising from the diversification of financial institutions' activities and their interconnections. Structural risks are related to the architecture and segments of the financial system.

The macroprudential policy aims to minimize systemic risks by addressing cyclical and structural vulnerabilities. While the macroprudential policy does not eliminate systemic risks entirely, it helps reduce the likelihood and impact of financial crises.

Chart 1. Cyclic metrics of the systemic risk across the financial cycle



The theoretical foundation of macroprudential policy was laid in the late 1970s. In the 1980s, although macroprudential policy was reflected in the documents of the Bank for International Settlements (BIS) as a new, separate policy aimed at maintaining the stability of the financial system, it became more relevant in the 1990s following the Japanese financial crisis and the Asian financial crisis at the end of the decade. In response to excessive capital inflows, central banks in Hong Kong (in the 1990s), South Korea, and Singapore (in the 2000s) implemented macroprudential tools. The global financial crisis of 2008-2009 further highlighted the necessity of implementing macroprudential policy. In response to the crisis, the active application of the Basel principles, which include macroprudential measures such as capital buffers and liquidity requirements designed to enhance the resilience of the financial system, began. Additionally, several new institutions, such as the Financial Stability Board (FSB) and the European Systemic Risk Board (ESRB), were created to monitor and mitigate systemic risks. As a continuation of this process, the ESRB developed a document with recommendations on the objectives and tools of macroprudential policy, and based on these recommendations, many countries adopted strategies for macroprudential policy.

The improvement of macroprudential policy in the context of new challenges and risks is an ongoing process. Recently, many advanced countries have been working on developing macroprudential policy not only for banks but also for non-bank financial institutions.

1.2. Principles of the macroprudential policy

Regulatory authorities follow several principles when implementing macroprudential policy to ensure the effectiveness of the policy:

1. Independence. The CBA's independence from its other functions, including monetary policy and micro prudential supervision, as well as from pressures from the financial sector or other public authorities when implementing macroprudential policy.

2. Transparency. Regular communication with the public regarding the objectives and expected outcomes of using macroprudential tools. The principle of transparency enhances the effectiveness of implemented macroprudential policy, boosts market confidence, and ensures accountability to the public.

3. Preventive approach. Taking appropriate steps for the early analysis and mitigation of systemic risks. The preventive approach allows timely assessment and elimination of systemic risks, thereby ensuring financial stability.

4. Substantiated judgment. The use of macroprudential tools in a strictly predefined manner may not fully address the sources of systemic risks. Hence, additional measures are identified based on substantiated judgment, and the tools are applied accordingly.

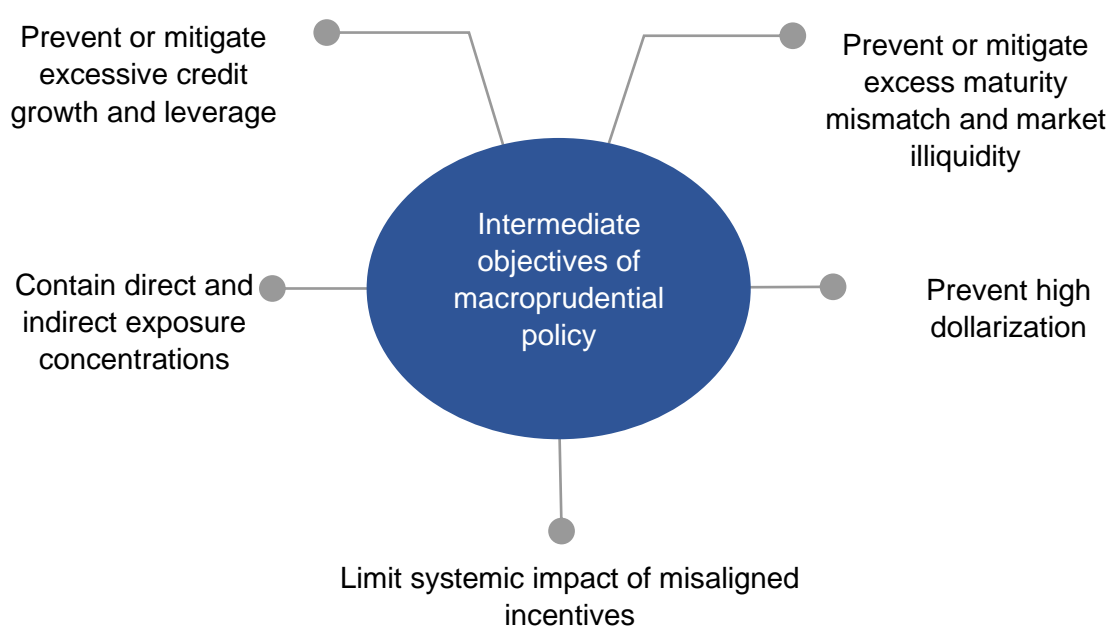
5. Coordination. The effectiveness of macroprudential policy depends on its interaction with other policies within the mandates of the regulator and various institutions. Appropriate policy coordination is ensured when implementing the macroprudential policy.

6. Proportionality. The application of macroprudential tools in accordance with the importance of financial institutions within the financial system. This principle ensures that the use of macroprudential tools is applied in a way that corresponds to the scale of risks that financial institutions may cause and the specific characteristics of those institutions.

1.3. Primary and intermediate objectives of the macroprudential policy

The **primary objective** of macroprudential policy is to safeguard financial system stability, a key prerequisite for sustained economic growth. To achieve this objective, intermediate objectives should be established. These intermediate objectives provide an economic basis for selecting appropriate tools, making macroprudential policy more prompt, transparent, and accountable.

Chart 2. Intermediate objectives of banking sector's macroprudential policy



Prevent or mitigate excessive credit growth and leverage – Excessive lending and high leverage pose risks to financial system stability. Excessive lending can lead to financial bubbles, as asset prices increase beyond their fundamental values. The bursting of these bubbles may result in financial crises. At the same time, high leverage can amplify borrowing by financial institutions, non-financial institutions, and households, making it more difficult for them to meet their debt liabilities, which could lead to defaults and potential cascading failures within the financial system. This intermediate objective aims to prevent the concentration of risks associated with excessive lending and leverage that threaten financial system stability.

Prevent or mitigate excessive maturity mismatch and market illiquidity – Excessive maturity mismatch arises when financial institutions fund long-term investments with short-term borrowings. A liquidity crisis can occur if short-term funding conditions tighten, or long-term investments cannot be quickly converted into liquid assets. This intermediate

objective is aimed at ensuring that financial institutions maintain a reasonable balance between maturities of their assets and liabilities.

Limit direct and indirect exposure concentrations – This intermediate objective focuses on managing risks that may arise from the concentration of banks' exposure to specific assets, sectors, or financial institutions. Such concentrations can trigger significant losses if the institution or sector faces financial difficulties. Direct concentration may stem from direct investments or loans, while indirect concentration may arise from derivative instruments or interconnections among financial institutions. By containing these concentrations, macroprudential policy aims to prevent systemic crises that could result from the failure of a bank or sector.

Limit the systemic impact of misaligned incentives – In the context of reducing moral hazard, limiting improper incentives is particularly relevant for large banks and other financial institutions. Because due to their systemic importance (too big to fail), they often believe they will be rescued by the state during crises. Expectations of government intervention during financial crises (e.g., emergency liquidity injection, recapitalization, resolution measures, etc.) can encourage financial institutions to engage in risky behavior before a crisis, thereby increasing systemic risks and undermining financial stability. While government interventions are essential to safeguard financial system stability, efforts should be made to promote more responsible behavior by financial institutions and prevent the creation of false incentives that assume the government will always provide a bailout.

Prevent high dollarization – Reducing dollarization enhances resilience against systemic risks by neutralizing the impact of external shocks on the financial system. Dollarization should be prevented to mitigate negative effects of price volatility in global commodity markets on the country's financial system. The CBA actively employs macroprudential policies to reduce dollarization and, thereby, mitigate the systemic risks it may cause.

2. Implementation of the macroprudential policy in Azerbaijan

2.1. Macroprudential policy mandate and institutional framework

The CBA is the primary executor of macroprudential policy. According to Article 4.2 of the 'Law on the Central Bank of the Republic of Azerbaijan' (hereinafter – the Law), the CBA ensures financial stability within the scope of its authority as defined by laws regulating financial markets, without compromising its primary objective¹. In accordance with Article 5.1.6 of the Law, the CBA is responsible for ensuring the stability and resilience of financial markets, regulating, and supervising financial markets, including conducting macroprudential regulation and supervision.

Without compromising the financial stability goal, the CBA takes measures aimed at the development of the financial sector. In this regard, the Bank adopted the '2024-2026 Financial Sector Development Strategy', which outlines priorities such as the development of key sectors of the financial system in the country, including insurance, capital markets, and payment systems, as well as further strengthening the resilience of the banking sector.

The implementation of macroprudential policy by the CBA involves four stages. These stages form a complete policy cycle and consist of the following:

1. Identification and Analysis of Systemic Risks: In this stage, vulnerabilities are identified, and their levels are assessed based on relevant indicators, in line with the intermediate objectives.

2. Selection and Calibration of Macroprudential Tools: In this stage, macroprudential tools are selected based on the size and nature of the systemic risk. The parameters for the application of these tools are then determined.

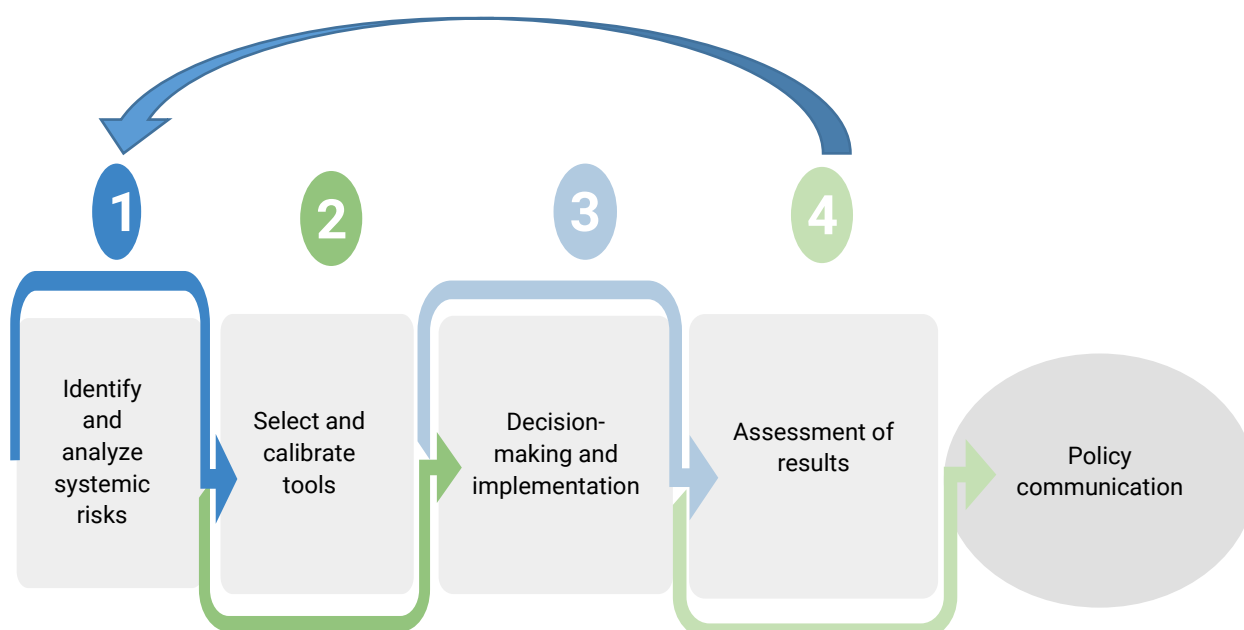
3. Decision-Making Mechanism and Implementation of Macroprudential Policy: In this stage, the selected tools are activated, and are implemented in practice.

4. Evaluation of Results of Macroprudential Tool Implementation: In this stage, the impact of the tools is assessed, and decisions are made regarding possible adjustments or regulatory actions.

The process is completed with effective communication of the policy.

¹ The main goal of activities of the Central Bank is to maintain price stability within the authorities specified in the Law of the Republic of Azerbaijan on the Central Bank of the Republic of Azerbaijan.

Chart 3. Stages of macroprudential policy implementation



2.2. Stage One - identify and analyze systemic risks

The CBA identifies systemic risks and their transmission channels that could impact the stability and resilience of the country's financial system. To assess their effects on financial stability, it develops various models and tools, including conducting stress tests and formulating policy tools to neutralize risks.

In identifying systemic risks, a variety of statistical and analytical methods, as well as substantiated judgments, are employed. The evaluation of systemic risks involves the use of stress testing, network models, various parameter simulations, and macro-financial models. When assessing systemic risks, recent trends in financial markets, including banks' strategies and business plans, qualitative surveys, and media reports, are also taken into account.

A top-down stress test is conducted to evaluate the capital resilience of banks under various adverse macro-financial scenarios and identify appropriate mitigation and policy measures. The stress test methodology assesses the financial condition of the entire banking system, as well as individual banks, under stress conditions over the coming years, which bank allows an evaluation of the financial health of the banking system, particularly the resilience of the banking sector to systemic risks and its overall ability to support economic stability. At the same time, the CBA establishes regulatory requirements for the bottom-up stress-testing process conducted by banks. The bottom-up stress-testing, conducted by banks at least twice a year, is evaluated to ensure that the results are incorporated into their risk management processes. Methodological support is provided to banks for conducting stress tests and improving their models. Supervisory measures are imposed based on the evaluation results.

The risks of influence and vulnerability among financial institutions are assessed using a network model. This model allows the evaluation of the impact on the overall financial system and individual institutions in the event of a hypothetical default by a financial institution.

To identify systemic risks, the AMB uses a range of indicators to monitor and assess potential vulnerabilities within the financial system. These indicators can be grouped as follows:

Table 2. Selected sample indicators used for the identification of systemic risks

Intermediate objectives of macroprudential policy of the banking sector	Indicator
<p>Prevent or mitigate excessive credit growth and leverage</p>	<ul style="list-style-type: none"> ▪ Credit gap ▪ Lending portfolio dynamics ▪ Leverage ▪ Dynamics of the loan to value ratio ▪ Dynamics of the debt-to-income ratio ▪ The non-performing loan ratio ▪ NPL coverage ratio ▪ Vintage analysis ▪ ROE of the banking sector ▪ Deviation of stock market indicators from long-term trend ▪ Dynamics of prices in the real estate market and deviation from long-term trend ▪ Similar term government securities and difference of the return on corporate securities ▪ Easing of lending standards and rise in demand (based on Credit Conditions Survey)
<p>Prevent or mitigate maturity mismatch and market illiquidity</p>	<ul style="list-style-type: none"> ▪ Market liquidity of securities ▪ The loan to deposit ratio ▪ The instant liquidity ratio ▪ The liquidity coverage ratio ▪ The funding structures ▪ Maturity mismatch of assets and liabilities

<p align="center">Contain direct and indirect exposure concentrations</p>	<ul style="list-style-type: none"> ▪ Sectorial concentration of the lending portfolio ▪ Loans to one borrower or a group of related borrowers ▪ Funding from one source or related persons ▪ Interaction of banks/financial institutions
<p align="center">Limit the systemic impact of misaligned incentives</p>	<ul style="list-style-type: none"> • Concentration indicators (HHI index, etc.) ▪ Market share of systemically important banks ▪ Banks' profitability indicators ▪ Net interest margin
<p align="center">Prevent high dollarization</p>	<ul style="list-style-type: none"> ▪ Dollarization of assets and liabilities ▪ The NPL ratio on foreign currency loans ▪ Net interest margin across currencies ▪ Open currency position

2.3. Stage Two - select and calibrate macroprudential tools

Tools derived from the intermediate objectives of macroprudential policy should be selected and calibrated properly to mitigate systemic risks and minimize potential adverse impacts on economic growth.

After identifying systemic risks, the CBA proceeds to the next stage of making decisions regarding the measures required to mitigate or eliminate those risks. Depending on the nature (cyclical or structural) and scale of the identified systemic risk, a list of potential tools or sets of tools that can be utilized is determined. When selecting macroprudential tools, potential outcomes of applying relevant tools are considered, and they are calibrated.

The CBA's macroprudential policy toolkit for the banking sector includes capital requirements in line with Basel standards, including the counter-cyclical capital buffer requirement. The toolkit also includes the debt-to-income ratio, the loan-to-value ratio, maximum credit exposure for a single borrower or a group of related borrowers, limits on related party transactions, the leverage ratio, the liquidity coverage ratio, including restrictions on foreign currency loans, differentiated risk weights for various credit categories, differentiated reserve requirements for foreign currency deposits, open currency position requirements, and other tools. In the context of improving the regulatory framework, the CBA may apply the Net Stable Funding Ratio (NSFR), individual capital buffers (Pillar II), and other tools on the backdrop of the adoption of additional capital requirement tools aligned with Basel III standards in future.

Macroprudential tools within the CBA's current regulatory framework for the banking sector:

The **countercyclical capital buffer (CCyB)** – a macroprudential tool designed in accordance with the economic cycle and the dynamics of lending portfolios. The CCyB is an essential instrument for regulating excessive lending growth, enhancing the resilience of the banking sector, and maintaining financial stability. During periods of rapid economic growth, the CCyB is activated, requiring banks to hold additional capital. By curbing excessive lending expansion, this buffer reduces the likelihood of potential financial crises. Conversely, during periods of economic downturn, the CCyB requirement is reduced or eliminated, allowing banks to utilize the accumulated additional capital to maintain lending and support economic activity.

The **leverage ratio** – regulates the expansion of banks' assets and liabilities relative to their capital and prevents excessive borrowing and accumulation of risky assets. As a result, it helps mitigate systemic risks in the financial system and prevents the spillover of crises.

The **liquidity coverage ratio (LCR)** – helps ensure that banks are prepared to withstand short-term liquidity pressures. It requires banks to hold sufficient high-quality liquid assets to meet their liquidity needs for the next 30 calendar days during periods of severe stress. This reduces the risk of financial crises spreading to the real economy.

The **debt-to-income ratio (DTI)** – the ratio of a borrower's debt burden to his/her income. The DTI ratio is applied to ensure that borrowers take on obligations commensurate with their income level, preventing over indebtedness and promoting sustainable creditability.

The **loan-to-value ratio (LTV)** sets the maximum loan amount relative to the market value of real estate or other collateral used as securitization. The LTV ratio helps ensure the resilience of the financial sector against risks arising from price volatility in the real estate market and contains the formation of potential bubbles originating from the real estate market.

The **reserve requirement ratio** – a portion of banks' liabilities to be held with the CBA. Reserve requirements can be differentiated based on the currency and type of liabilities. Both monetary policy and macroprudential targets are set with respect to these reserves. As a macroprudential tool, the reserve requirement is applied in a way that aligns with the primary objectives of CBA's operations without compromising them

Macroprudential tools the CBA may apply in future for the banking sector:

The **capital conservation buffer** – a tool designed to prevent the breach of minimum capital requirements during economic difficulties. With the capital conservation buffer, banks create additional capital reserves under normal economic conditions, allowing them to maintain minimum capital resilience by mitigating potential financial losses. If the capital conservation buffer decreases, restrictions may apply to the distribution of banks' earnings (dividends, bonus payments, etc.) to ensure maintenance of minimum capital requirements

Capital buffers for sectoral concentration – are designed to reduce systemic risks arising from concentration in specific sectors. This buffer imposes additional capital requirements on individual banks when the risk in certain sectors is high.

The systemically important bank buffer (O-SII) – is a capital buffer designed to enhance the resilience of systemically important financial institutions. This buffer aims to ensure the sustainability of these institutions during potential crisis situations by requiring them to hold additional capital.

The systemic risk buffer – a proactive macroprudential tool designed to enhance banks' ability to absorb losses and limit the spread of systemic risks. This buffer imposes additional capital requirements on banks to prevent risks that are not covered by the counter-cyclical buffer or the systemically important banks (O-SII) buffer.

The **net stable funding ratio (NSFR)** is defined as the ratio of available stable funding to required stable funding. This tool sets the minimum portion of stable (long-term) funding in relation to the liquidity and maturity distribution of bank's assets. The NSFR encourages banks to rely on stable funding sources, thereby ensuring funding sustainability.

Individual capital buffer requirements – additional capital requirements set by the regulatory authority within the framework of Basel Pillar II (Supervisory Review Process). These buffers are applied to cover various idiosyncratic risks that are not fully addressed by the capital requirements defined under Basel Pillar I, including interest rate risk on the bank's balance sheet, credit concentration risk, counterparty credit risk, risks arising from the business model, and results of stress tests.

The list of macroprudential tools applied and to be applied by the CBA in the banking sector is summarized in Table 2. The list of tools is regularly updated and improved with the introduction of additional measures, in line with the nature of the financial sector.

Table 3. Intermediate objectives of banking sector's macroprudential policy and appropriate tools

Intermediate objectives				
Prevent or mitigate excessive credit growth and leverage	Prevent or mitigate excessive maturity mismatch and market illiquidity	Limit direct or indirect exposure concentrations	Limit the systemic impact of misaligned incentives	Prevent high dollarization
Macroprudential tools				
<ul style="list-style-type: none"> ▪ Countercyclical capital buffer ▪ Leverage ratio ▪ LTV ratio ▪ DTI ratio ▪ Maximum loan maturity ▪ RWA rate for various lending categories ▪ Loan to income ratio ▪ Debt-to-operating profit ratio for legal entities ▪ Systemic risk buffer ▪ Capital conservation buffer ▪ Sectoral capital requirement ▪ Additional capital requirements based on stress test findings ▪ Individual capital buffer requirements 	<ul style="list-style-type: none"> ▪ Instant liquidity ratio ▪ Liquidity coverage ratio (LCR) ▪ Reserve requirements** ▪ LTD ratio ▪ Net stable funding ratio (NSFR) ▪ Individual liquidity buffer requirements 	<ul style="list-style-type: none"> ▪ Limits per borrower ▪ Limits on related party transactions ▪ Reserve requirements** ▪ Limits on funding from one source or related parties ▪ Capital buffers on sectoral concentration ▪ Individual capital buffer requirements 	<ul style="list-style-type: none"> ▪ Additional capital buffer on systemic banks ▪ Leverage ratio on systemically important banks ▪ Maximum amount of the credit risk of a systemically important bank on another systemically important bank ▪ Systemically importance buffer (O-SII) ▪ Other capital buffers on systemically important banks 	<ul style="list-style-type: none"> ▪ Open currency position requirements ▪ Limits on foreign currency borrowing ▪ Differentiated RWAs for foreign currency-denominated assets ▪ Differential approach on reserve requirement in foreign currency ▪ LCR in foreign currency ▪ Individual capital buffer requirements

* The tools shown in black are already in use or are enabled by the existing regulatory framework. As part of the improvement of the regulatory framework, the CBA may implement other tools (shown in blue) in the future

** The specified tools should be implemented without compromising the core objectives (e.g., monetary policy).

2.4. Stage Three - decision-making mechanism and implementation on the macroprudential policy

The Management Board of the CBA is the collegial governing body responsible for macroprudential policy decision-making.

The CBA's Monetary Policy and Financial Stability Committee (the Committee) is a collegial body that regulates and coordinates operational activities of the CBA's structural units in financial market regulation and supervision. The Committee is chaired by the Governor of the Central Bank. Its members are the heads of the units directly involved in the development and implementation of monetary and financial stability policies.

The Committee holds regular meetings, including at least quarterly financial stability and macroprudential policy meetings.

The Committee submits proposals to the Management Board regarding the implementation of appropriate macroprudential policy tools based on an in-depth and comprehensive diagnosis of risks. When developing macroprudential policy proposals, both quantitative and qualitative analyses, as well as substantiated judgements are considered. This includes, first and foremost, analytical materials prepared at earlier stages, including key indicators for risk assessment and their respective thresholds, and the results of analyses of the information on expected transmission mechanisms of selected tools and their calibration. Additionally, legal aspects and interactions with other policy areas are also considered.

The Management Board makes decisions on the implementation of macroprudential tools and oversees their execution. In the macroprudential policy decision-making, the first step is to assess whether intervention is needed for the identified systemic risks. Subsequently, the suitability of selected tools for intermediate objectives and their consistency with the goals of other policies are evaluated. Additionally, attention is paid to minimizing side effects of the selected tool and preventing regulatory arbitrage. Timely communication of information to market participants, as well as addressing market expectations appropriately is also a priority when policy measures are introduced or reviewed. The CBA keeps the public and market participants informed about macroprudential policy decisions through press releases and press conferences.

2.5. Stage Four - assess the outcome of implementation of macroprudential tools

After implementing macroprudential tools, the CBA regularly monitors outcomes. Evaluating results of applying macroprudential tools allows assessing their effectiveness and efficiency, measuring their impact on mitigating systemic risks, and improving their regulation. The assessment of the impact of macroprudential tools on the financial system is based on

the analysis of individual bank reports, key banking system indicators, and the market's adaptation to changes.

The evaluation of the results of applying macroprudential tools involves making additional interventions if necessary or deciding on changes to existing regulations. The Bank closely monitors the impact of the implemented tool on financial system stability and its contribution to economic growth.

2.6. Macroprudential policy communication

The organization of macroprudential policy communication is one of the key pillars of CBA's macroprudential policy. Effective communication of macroprudential policy is crucial for its successful implementation. By focusing on transparency, public awareness, and coordination with other policy areas, the CBA strives to enhance the effectiveness of its macroprudential policy. Macroprudential policy communication is conducted through various channels. The Financial Stability Report ensures that the macroprudential policy is well understood by market participants and the broad public, facilitating its effective implementation. The CBA uses various communication channels, such as its official website, social media, and traditional mass media, to reach a broad audience. This provides a foundation for the Bank to foster a better understanding of risks among market participants and the public and to ensure accountability.

The CBA has been publishing the Financial Stability Report on a semi-annual basis since the second half of 2021. The Report provides a comprehensive assessment of financial sector stability and the factors that determine its resilience, as well as reflects the priority macroprudential policy measures implemented and planned by the Central Bank to maintain financial stability.

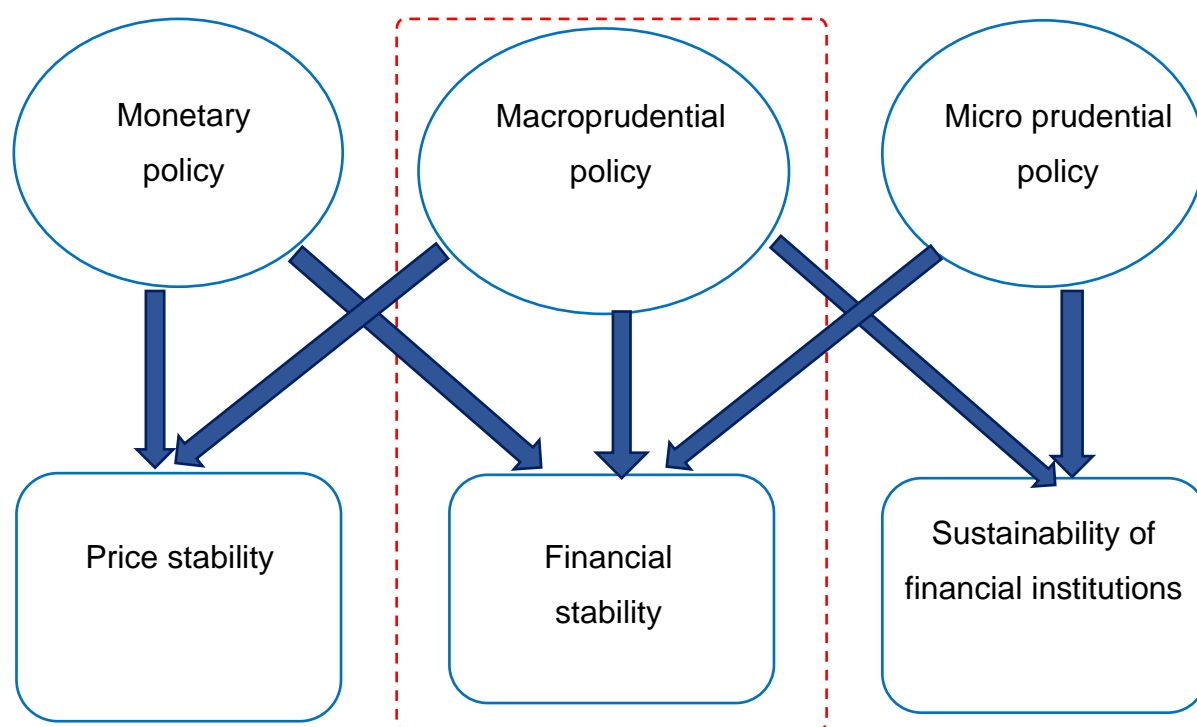
The CBA has been publishing results of the Credit Conditions Survey quarterly since the first quarter of 2022. The purpose of the survey is to monitor and analyze lending activities of the banking sector, detect, and assess threats to financial stability in an early stage, identify appropriate prudential policies, and inform financial sector participants about relevant trends.

In addition to official reports and press releases, the CBA evaluates both forward-looking and retrospective feedback from market participants, such feedback supports the effective organization of regulation. This approach not only enhances transparency but also ensures that the views and concerns of stakeholders are taken into account in the policy making process.

3. Macroprudential policy's interaction with other policies

Macroprudential policy's interaction with other policies is crucial in safeguarding financial stability and making the policy implemented effective. Macroprudential policy mainly interacts with the monetary and micro prudential policies. It also interacts with sustainable finance, fiscal policy, and other economic policies.

Chart 4. Macroprudential policy's interaction with other policies



Interaction with the monetary policy

The interaction between macroprudential and monetary policies is essential for ensuring the stability of both the economy and the financial system. Monetary policy focuses on price stability, while macroprudential policy aims to safeguard financial system stability by mitigating systemic risks and enhancing the economy's resilience to shocks.

Although the objectives of monetary and macroprudential policies are different, they complement each other. A low inflation rate helps effectively implement macroprudential policy. At the same time, it is difficult to ensure price stability in the context of financial system instability. Financial system stability allows increased effectiveness of monetary policy and enhances its transmission to the real economy.

Coordination between monetary and macroprudential policies is crucial. However, conflicts may arise between these two policies at times. For instance, during inflationary

pressures, central banks typically implement a policy of raising interest rates. This may conflict with the objectives of macroprudential policy in the financial system. In such cases, effective coordination between both policies is required to ensure both macroeconomic and financial stability. Coordination between the two policies helps achieve short-term economic goals while also maintaining long-term financial stability. The complementarity and interaction of these policies ensure that the economy becomes more resilient and sustainable against shocks.

Interaction with micro prudential policy

Macroprudential policy is closely interconnected with micro prudential supervision. While the goals and approaches of these two policies differ, they complement each other. Micro prudential supervision is focused on ensuring the resilience of institutions, whereas macroprudential policy aims to prevent systemic risks that could affect the entire financial system.

Under the micro prudential policy framework, activities of banks and other financial institutions are supervised on a risk basis. Micro prudential policy supports financial stability by ensuring the health of individual financial institutions and their ability to meet their obligations.

The information obtained through micro prudential supervision is crucial for the effectiveness of macroprudential policy. Data gathered from on-site inspections and monitoring risk exposures of individual institutions can play a significant role in determining macroprudential measures. At the same time, macroprudential policy can influence micro prudential supervision by defining the broader regulatory environment in which individual institutions operate. Well-organized coordination ensures that the two policies create synergy, enabling the effective achievement of the objectives of both policies.

The effective coordination of macroprudential policy with other policies can mitigate systemic risks and ensure that the financial system supports sustainable economic growth. Continuous communication and cooperation are essential to manage potential conflicts and synergies between these different policy areas.

4. Macroprudential policy across non-bank areas

The CBA regularly evaluates activities and financial positions of non-bank financial institutions (NBFIs) and takes necessary steps to enhance their financial resilience. The Bank has the initiative to apply relevant macroprudential tools and make changes to the regulatory legal framework.

The increasing share of NBFIs globally, their diverse activities, and potential impact on financial stability make it necessary to develop a macroprudential policy strategy and toolkit for them. Although several specialized international organizations, such as the ESRB, EIOPA, and ESMA, are working in this direction, an effective macroprudential policy framework for the non-bank sector is still in its early stages of development.

As is the case globally, in our country, the insurance sector, being the largest non-bank financial sector, plays a significant role in sustaining financial stability.

While traditional insurance activities are not a primary source of systemic risk, as part of the financial system, the insurance sector is capable to influence financial stability both directly and through its connections with other financial institutions and can amplify the impact of adverse shocks on the financial system.

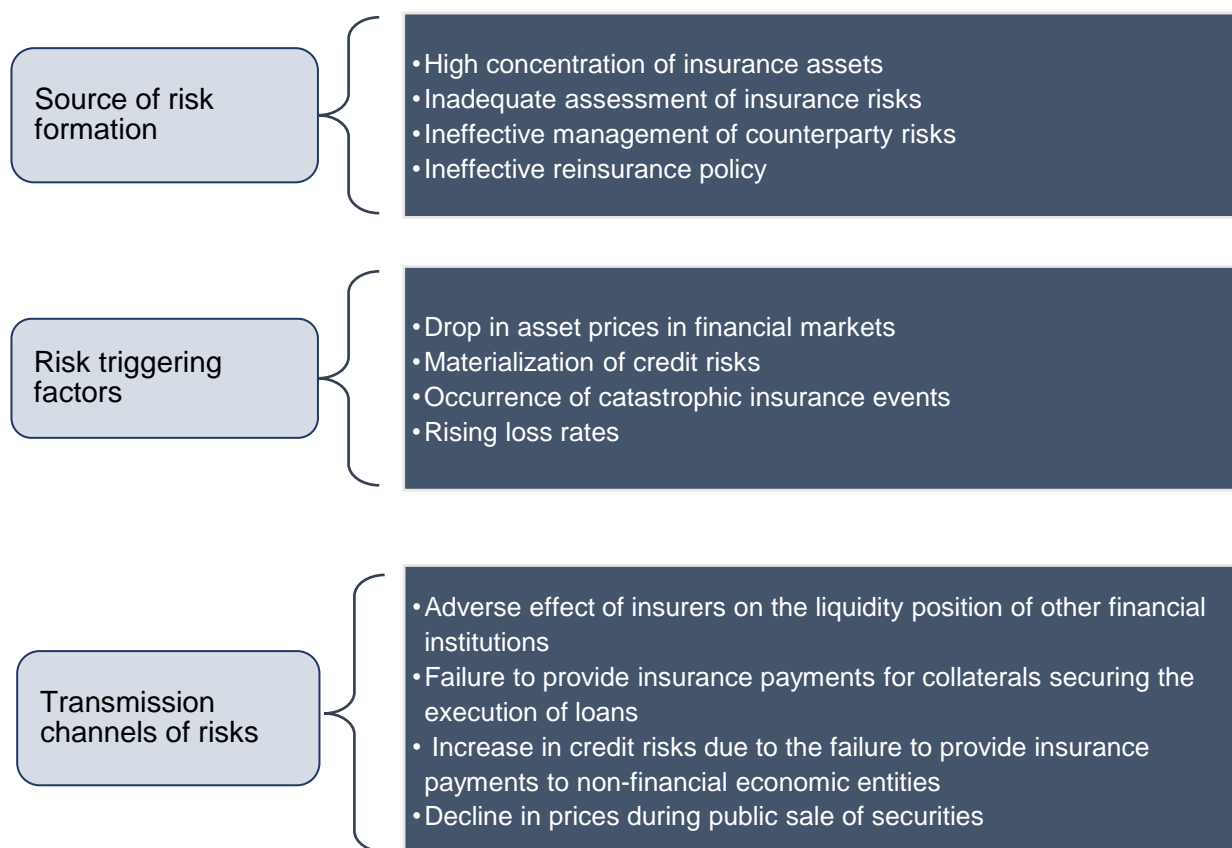
The impact of the insurance sector on systemic risks can be divided into three stages:

- 1) Emergence of risks that pose a potential threat to the financial system
- 2) Adverse impact of emerging risks on insurance institutions
- 3) Transmission of risks that adversely affect insurance institutions to the financial system

Incorrect investment policies, underestimation of insurance risks (inadequate calculation of insurance premiums, incorrect underwriting policies, creation of insufficient insurance reserves, including failure to properly account for catastrophic risks, and increasing loss ratios), and ineffective reinsurance policies may lead to the deterioration of the financial condition of insurance institutions and, as a result, the emergence of systemic risk.

Responses of insurers to shocks can directly or indirectly amplify negative events in financial markets, potentially spreading across the entire financial system.

Table 4. Systemic risks and transmission channels on the insurance sector



In a case a systemically important insurer or several insurers lose financial viability, it may:

- 1) lead to non-payment of insurance claims, causing other financial institutions to incur losses.
- 2) negatively affect the liquidity position of other financial institutions
- 3) trigger a public sale of securities, leading to a decline in securities market prices.

Risks in the insurance sector are assessed and continuously monitored based on the sensitivity to various macro-financial risks (interest rates, exchange rates, stock indices) and insurance-specific indicators. The key metrics specific to insurance include insurers' capital adequacy, the dynamics of loss and expense ratios, underwriting indicators, the adequacy of insurance reserves, and other related measures.

The decision to adjust parameters of macroprudential policy and select appropriate macroprudential tool depends on the insurance sector's resilience to existing and potential risks and the effectiveness of the current prudential tools.