Occasional Papers on Islands and Small States

CREATING A STABLE FINANCIAL ENVIRONMENT

Oliver Bonello

No: 4 /2001

ISSN 1024-6282

This is a discussion paper which the author/s submitted for feedback from interested persons. The author/s are free to submit revised version of this paper for inclusion in other publications. An electronic version of this paper is available at www.um.edu.mt/islands. More information about the series of occasional papers can be obtained from the Islands and Small States Institute, University of Malta. Tel/Fax: 356-21344879, email: islands@um.edu.mt .

CREATING A STABLE FINANCIAL ENVIRONMENT[1]

Monetary and financial stability are of central importance to the effective functioning of a market economy. Stability in the financial sector improves the climate for channelling savings to investment and promotes the efficiency of the payment system. Disruptions in the financial sector can have severe adverse effects on economic activity and even on political structures. Maintaining stability is therefore the key objective of the financial authorities.

Financial stability has been defined as a condition where the financial system is able to withstand shocks without giving way to cumulative processes that impair the allocation of savings to investment and the processing of payments in the economy.[2] Severe financial instability, worse still a crisis, can be very costly. Output and growth opportunities are foregone. Severe financial distress can numb the effectiveness of standard macroeconomic tools, such as monetary and fiscal policies. The very social fabric of society can also come under strain as the experience of a number of emerging market economies attests. Over the past twenty years various countries experienced a banking crisis, with average costs ranging between 15% and 25% of GDP.[3] Countries affected included developed, transitional and developing countries alike. A crisis can hit a country irrespective of the size of its economy. The fiscal costs of a crisis in emerging market economies tend to be higher than those in developed countries, although a crisis in a large economy normally has a higher financial impact and/or a contagion effect on other countries. Therefore, the latter would be more of a threat to global financial stability. Higher interest rates, deterioration in banks' balance sheets, stock market declines and increases in uncertainty are among the factors that bring about financial instability. If all of these factors occur at the same time, and are substantial, the situation is likely to escalate into a full-scale financial crisis, with the consequent negative effects on the real economy.

Central banks have been concerned with financial stability issues since their inception. In many countries, price stability has been formally set as the main objective of the central bank. But price stability and financial stability are often seen as complementary: price stability contributes towards financial stability in the same way as a sound and efficient financial system enhances the implementation of monetary policy. The role of maintaining financial stability is therefore also an intrinsic part of a central bank's key monetary policy objective. This role has evolved as financial systems grew and became more sophisticated.

To create a financial sector that is more resilient to instability, whether emanating from shocks *within* a country's system (endogenous risks) or shocks that arrive from *outside* the system (exogenous risks), countries have taken several measures to reform their financial sector. Such reforms have affected the legal framework; financial sector oversight and the regulatory/supervisory structure; financial market infrastructure; payment systems; systemic protection through a public safety net; corporate governance and the overall risk management process; market discipline; fiscal policies; and the independence of the central bank.

Such reforms also increase the country's level of adherence to international standards and codes.

A high level of adherence to such standards and codes is conducive to better identification of sources of vulnerability. The adoption of internationally accepted standards and codes of good practice makes an important contribution to a sounder financial sector and better functioning of financial markets. It also leads to better and more informed lending and investment decisions and better and more accountable policymaking. The main key standards and codes cover: transparency in monetary and financial policy; fiscal transparency; data dissemination; corporate governance; auditing and accounting; payment systems; banking supervision; securities and insurance regulation; market integrity and insolvency regimes.

Apart from the structural inefficiencies in the financial framework itself, and particularly in the banking system, an unstable macroeconomic environment is a key source of vulnerability in the financial system. Significant swings in the performance of the real economy, volatile interest rates, exchange rates, asset prices and high inflation rates make it difficult for banks and other financial institutions to assess accurately the credit and market risk they incur. Banks in many small developing and transition economies have limited scope to diversify these risks as much as

1 This article is an abstract version of the first part of a paper entitled "Creating a Stable Financial Environment in Small Island States" presented by Mr Oliver Bonello, Senior Manager, Financial Stability Department, during the 2002 seminar organised by The Islands and Small States Institute – Foundation for International Studies, Valletta, Malta.

2 Tommaso Padoa-Schioppa "Central banks and financial stability". Frankfurt, European Central Bank, 2002.

3 Glenn Hoggarth and Victoria Saporta "Cost of banking instability: some empirical evidence". London, Bank of England, 2001.

is possible in larger industrial economies. Furthermore, large and volatile international capital flows often add to the challenges faced by banks in small and/or emerging countries. Therefore, sound macroeconomic policies are also major contributors to a stable financial system.

The following are some important institutional aspects of a stable financial environment.

The Legal Framework

A market economy requires stability and confidence to operate effectively and efficiently. The confidence that is necessary to support the financial system in a market economy requires a well-developed legal and regulatory framework.

Inadequacies in a country's legal system should be eliminated and a sound legal framework should be introduced and kept updated with developments in the markets. A sound and effective legal framework is not a guarantee against crises, but past crises have shown that inadequacies in a country's legal system contribute to the high cost of a crisis and delay the subsequent recovery.

The Regulatory Regime

Another important requisite for achieving financial stability is a strong prudential, regulatory and supervisory regime. In 1997 the Basel Committee on Bank Supervision issued a set of twenty-five 'Core Principles for Effective Bank Supervision' which now serve as a benchmark against which the effectiveness of different banking supervisory regimes can be assessed. In 1999 the Committee also published the 'Core Principles Methodology' to assist countries in their assessment of the level of compliance with the twenty-five core principles. The respective global authorities for insurance and securities regulation and for payment systems have issued similar benchmarks.

The independence of the supervisory agencies is very important. Independent supervisors can be in a better position to limit forbearance when dealing with problems in individual banks. An effective supervisory regime needs to be sufficiently transparent such that the supervisors can be seen to be exercising their powers to favour the objectives of maintaining a stable and sound financial system.

Remedial Action and Exit Policies

The proper role of central bank lender-of-lastresort facilities is to promptly provide temporary support to illiquid but solvent institutions, typically at a penalty rate and against collateral. Such lending can be an important instrument to prevent banking panics and runs that could cause sound institutions to become illiquid and precipitate their insolvency. In order for a lenderof- last-resort to operate effectively, without undermining market discipline, the central bank needs sufficient information from the supervisory authority to determine which banks are approaching insolvency, to be able to limit support to sound but liquidity-constrained institutions.

Apart from being independent, supervisors also need sufficiently flexible powers to efficiently deal with problematic banks. Where problems are remediable, supervisors will normally seek to identify and implement solutions that fully address their concerns; where they are not, the prompt and orderly exit of institutions that are no longer able to meet supervisory requirements is a necessary part of an efficient financial system. In some instances, the fiscal authorities may support insolvent institutions, particularly if they are systemically important. Deposit insurance arrangements are designed to compensate some classes of depositors in case of individual bank failures. A credible exit policy for problem banks is necessary for effective deposit insurance and lender-of-last-resort arrangements and for the maintenance of a sound and competitive banking system.

Public Infrastructure and Market Discipline

A well-developed public infrastructure can significantly contribute to the stability of the financial system. Such facilities would normally cover: a system of business laws including corporate, bankruptcy, contract, consumer protection and private property laws; comprehensive and well-defined accounting principles and rules that command wide international acceptance; a system of independent audits for companies so that users of financial statements, including banks, have independent assurance that the accounts provide a true and fair view of the financial position of the company and are prepared according to established accounting principles, with auditors held accountable for their work; effective banking supervision with well-defined regulations; and a secure and efficient payment and clearing system for the settlement of financial transactions where counterparty risks are controlled.

Effective market discipline is another line of defence against financial instability. This depends on an adequate flow of information to market participants, appropriate financial incentives to reward well-managed institutions, and arrangements that ensure that investors are not insulated from the consequences of their decisions. Among the issues to be addressed are corporate governance and ensuring that accurate, meaningful, transparent and timely information is provided by institutions to investors and creditors.

Corporate Governance

Recent company failures have led to widespread questioning of the quality and integrity of the information available to the market and the behaviour of some corporate executives. This has drawn further attention to the importance of sound corporate governance based on independent oversight and strong internal checks and balances. Competition in the financial system is becoming more intense, and the overall structure of the financial system is increasingly adapted to change. In such an ever-changing and challenging environment it has become critical for financial institutions in general, and banks in particular, to be managed by fit and proper directors and managers within a sound and prudent system of corporate governance.

The Organisation for Economic Co-operation and Development (OECD) has defined corporate governance as “a set of relationships between a company’s management, its board, its shareholders and other stakeholders”. The adoption of sound governance principles by boards of directors will strengthen the risk management process, which, in turn, will make businesses more efficient and resilient to instabilities.

Market participants and the regulatory authorities share between them the process of instilling and using sound governance practices. While market participants bear the ultimate responsibility for establishing good governance practices in their institutions, in order to gain and keep the confidence of their shareholders, clients, counterparties and the markets, regulatory authorities play a key role in instilling and overseeing implementation of the use of such