Defining Financial Stability and a Framework for Safeguarding It

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Banco Central De Chile
Conference on Financial Stability, Monetary Policy, and Central Banking
November 6-7, 2008

Disclaimer

The views expressed are mine and not necessarily those of the IMF or other organizations.

Road Map

- Review existing policy framework for safeguarding financial stability
- Discuss what went wrong and weaknesses revealed by the ongoing global systemic crisis.
- Examine key issues in defining the financial stability challenge so policies focus on the ultimate objective of economic stability and efficiency
- Highlight the need for a system-wide and systematic approach

Road Map

- Review existing policy framework for safeguarding financial stability

Lines of defense against systemic financial problems

- Private risk management and governance
- Market discipline – adequate disclosure via financial reporting and market transparency
- Appropriate regulations, oversight of financial institutions and markets, and legal enforcement
- Crisis management and resolution (more detail later)

Oversight Regimes For Systemic Risk Management

	Sources of Global Financial Systemic Risk		
Lines of Defense	Global Financial Institutions	Global Money and OTC Derivatives Markets	Unregulated Activities
Pvt. Risk Mgt & Market Discipline	Partial	Primarily	Exclusively
Market and Banking Regulation	National with cooperation	Not really; over-the-counter transactions	No
Prudential Supervision	National and Home/Host Issues	n.a.	No
Market Surveillance	Indirect, as participant	Direct; National and International	Indirect, as participant

Crisis management and resolution

- Deposit insurance
- Liquidity provision to maintain smoothly functioning markets
- Lender of last resort operations to prevent market dysfunctioning and illiquid but viable financial institutions from failing
- Capital injections (private preferred to public) to maintain orderly transitions for institutions that are not viable

Roles of Central Banks

- Achieve and maintain monetary stability
- Safeguard financial stability – which is closely linked to monetary stability in times of stress – via banking supervision and market surveillance
- Maintain smooth functioning of monetary transmission process – sound financial institutions and well-functioning financial markets and infrastructures

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Global Financial Systemic Crisis – What went wrong?

- Global imbalances - mismatch between wealth accumulation and supply of financial assets
- Financial innovation gone astray
- Complexity and opacity of risk exposures
- Excessive leverage encouraged by
  - Interest rates – too low for too log
  - Risk-mgmt and governance failures
  - Excessive liquidity creation
  - Regulatory/supervisory laxity

Global Financial Systemic Crisis – What went wrong?

(continued)

- Compensation incentives mis-aligned with preserving/growing shareholder value
- Official oversight proved to be inadequate
- Central bank tools initially inadequate to deal with market dysfunctioning
- National treasuries needed new tools and fiscal authorities (at least in the United States)
- FS framework ignored important linkages between economic and financial stability

What is needed to restore stability?

- Back-stop/Insure key bank liabilities -- new unsecured debt issuance for example
- Recapitalize systemically important financial institutions
- Restore mechanisms for asset valuation
- Global problem needs global solution
- Are we there yet???

What needs to be done LATER?

- Fix breaches in lines of defense
  - Bank capital requirements on off-balance-sheet and structured-product credit exposures
  - Regulatory limits on leverage
  - Enhance disclosure and market transparency
  - Re-align compensation incentives with shareholder interests
- Hold bank executives, prudential supervisors, market regulators, and market monitors accountable
- Link framework for safeguarding financial stability more closely to monetary and economic stability

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What is the meaning of financial stability

- At least three aspects:
  - Financial resources are being efficiently and smoothly reallocated from savers to investors
  - Financial risks are being assessed and priced accurately and they are being efficiently managed
  - Financial imbalances can be comfortably absorbed and dissipated
- Both exogenous and endogenous elements
- First two also highlight dynamic and forward-looking aspects of finance – FS framework should aspire to intertemporal stability and efficiency

What is the Financial Stability Challenge

- Maintain smooth functioning of financial system and its ability to facilitate and support efficient functioning and performance of economy.
- Prevent financial systemic threats to economic stability
- Resolve systemic problems when prevention fails.

Complexities of Assessing and Safeguarding Financial Stability

- Overall objective is economic stability and efficiency and not FS per se
- FS occurs along a continuum; and not a static equilibrium
- Cannot summarize FS in a single quantitative indicator
- Developments in FS are difficult to forecast
- Policies aimed at FS may involve trade-offs between efficiency and volatility/resiliency
- FS is only partially controllable

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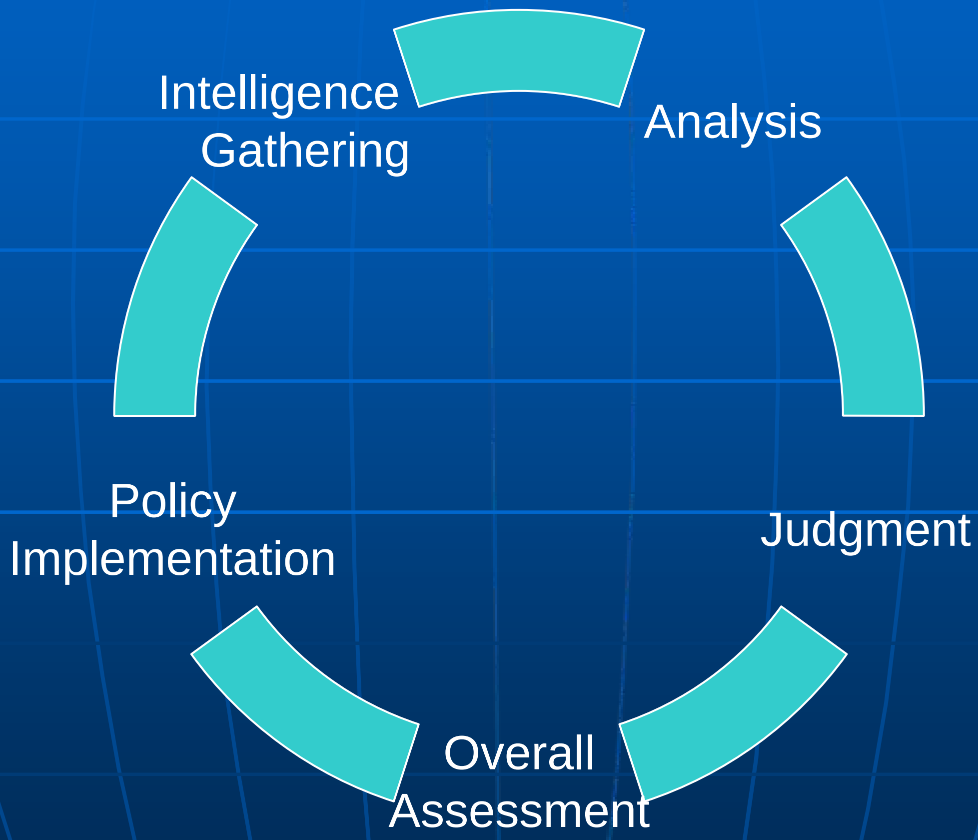
Objectives Of Financial-Stability Frameworks

- Early identification of potential risks and vulnerabilities of systemic problems
- Promote preventive and remedial policies to eliminate threats to systemic stability
- Resolve systemic events (‘disasters’) and instabilities when preventive and remedial measures fail

Safeguarding FS Is A Continuous Process



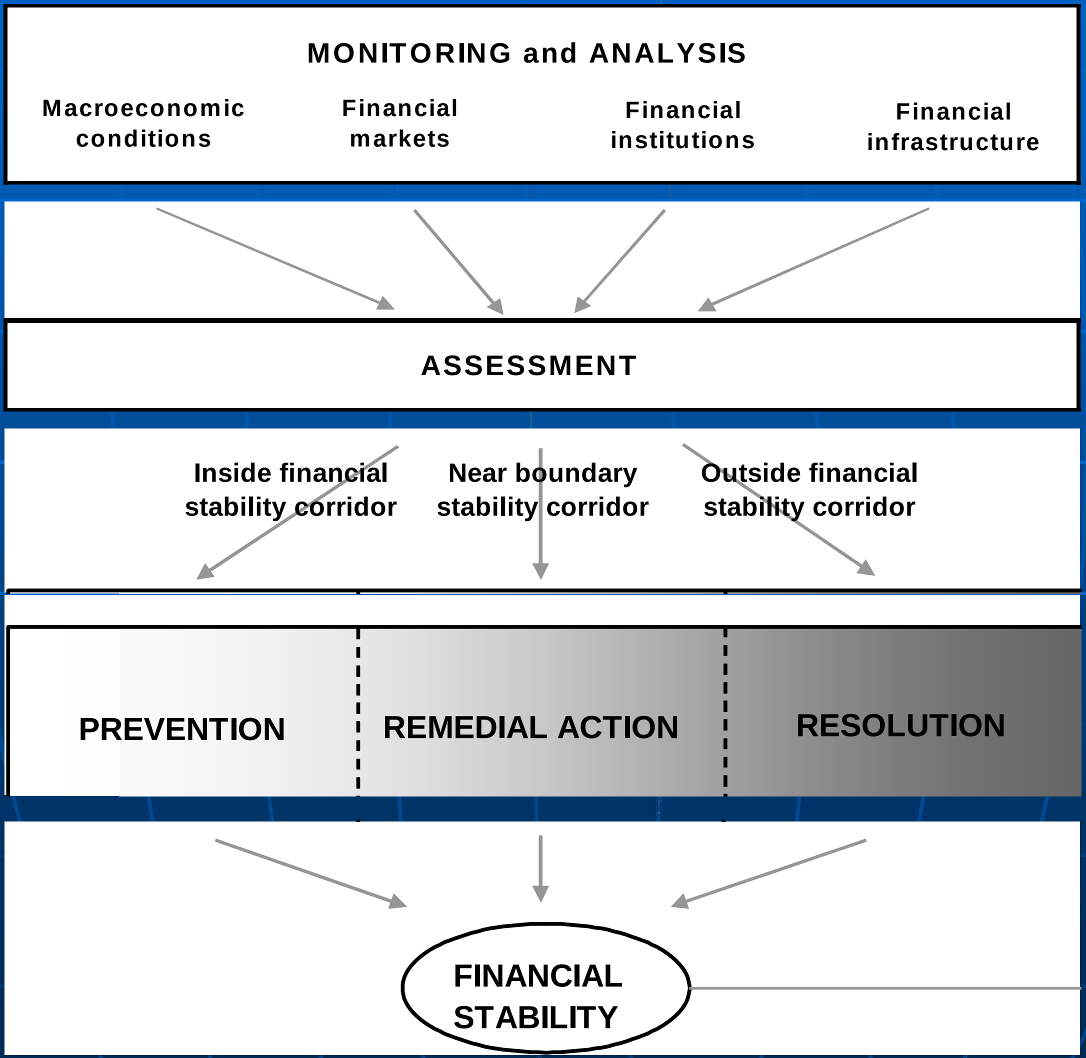
Assess Financial Sources of Risks and Systemic Vulnerability

- Endogenous sources
  - Institutions based
  - Market based
  - Infrastructure based
- Exogenous sources

Sources of Risk

Endogenous	Exogenous
Institutions-based • Financial risks (credit, market, liquidity) • Operational risk • Information technology weaknesses • Legal or integrity risk • Reputation risk • Business strategy risk • Concentration risk • Capital adequacy risk *Market-based* • Counterparty risk • Asset price misalignment • Run on markets (Credit, Liquidity) • Contagion *Infrastructure-based* • Clearance, payment, and settlement risk • Infrastructure fragilities (legal, regulatory, accounting, supervisory) • Collapse of confidence leading to runs • Domino effects	*Macroeconomic disturbances* • Economic-environment risk • Policy imbalances *Event risk* • Natural disaster • Political events • Large business failures

Need Integrated and System-Wide Approach of Analyses & Assessment



Need Systematic Approach for Identifying Risks and Vulnerabilities

- Is the process *systematic*?

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Checklist for Identifying Risks and Vulnerabilities

- Is the process *systematic*?
- Are the risks identified *plausible (avoid unconstrained "what if's?")*
- Are the risks identified *systemically relevant* (avoid the "encyclopedia of risks" and focus on risks that could, if they crystallize, have systemic implications)

Checklist for Identifying Risks and Vulnerabilities
(continued)

- Can *linkages* and *transmission (or contagion) channels* be identified?
- Have risks and linkages been *cross-checked* across indicators and models?
- Is the process *tracking the escalation <u>and fading of</u> risks over time?*

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Detail: Private risk management

- Financial-risk management at business-line levels
- Enterprise risk management at firm level
- Management controls at executive and senior-management
- Corporate governance at Board level
- Self-regulation via development/promotion of best business practices

Detail: Market discipline

- Sound accounting and valuation procedures for properly recording and valuing financial transactions/statements
- Timely reporting and disclosure to allow investors to assess risks
- Well functioning markets for price discovery and resource and risk allocation
- Legal infrastructure for enforcement of financial contracts

Detail: Official Involvement

- Transparent and enforceable legal infrastructure
- Effective market regulation and surveillance
- Effective oversight of financial institutions
  - Banks most heavily regulated/supervised
  - Investment banks subject to SEC regulations
  - Insurance/reinsurance lightly regulated
  - Others institutional investors lightly regulated
  - Hedge funds not regulated