Financial System Soundness

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Recent financial system crises in both industrial and developing countries have sparked a reexamination of how to prevent and respond to such crises. Better regulation and supervision are the key to dealing with them.

FOR ALMOST four decades after World War II there was not much need for anyone but central bankers and supervisors to pay attention to the banking system. Deposit insurance seemed to be doing its job of preventing bank runs, and regulators and regulations seemed to ensure that individual banks were acting prudently. Macroeconomists periodically returned to the question of what distinguished banks from other financial intermediaries, and whether it mattered, but no major changes in thinking about policies for promoting financial sector soundness resulted.

The problem of banking and financial system soundness has shifted to center stage in the last two decades. The international debt crisis threatened the health of major money center banks; the US savings and loan crisis demanded a huge injection of public funds; and major banking crises erupted in Scandinavian countries and, more recently, in Japan. Financial crises in some Latin American countries have been exacerbated by banking system weaknesses. In the transition countries, the need to recapitalize banks puts major strains on the budget, while the weaknesses of banking systems delay growth.

These financial system crises are not only costly for the economy but also reduce the effectiveness of monetary policy. They are costly because the volume and efficiency of financial intermediation are reduced when banks are being closed on a large scale or are struggling to strengthen their portfolios. They impair the effectiveness of monetary policy because banks in trouble do not react appropriately to interest rate changes and because the central bank has to exercise caution in using monetary policy for fear of damaging fragile banks.

Domestic financial deregulation undertaken before adequate reform of prudential supervision and the regulatory framework is one major reason that financial crises have become more common. Financial innovation—producing new and little-understood instruments that outstrip the reach of regulators—is another. Undertaking external financial liberalization—the removal of capital controls—before the soundness of the domestic financial system and macroeconomic policy is assured, is a third factor in explaining crises.

In this era, as in earlier times, some banking system crises have been caused by the bursting of asset price bubbles. Inappropriate monetary policy may have contributed to the behavior of asset prices, but financial markets on occasion get carried away with enthusiasm. The worldwide real estate boom in the late 1980s was ended by higher interest rates, with serious consequences for bank lending in the United States, and especially, Japan. There is no easy answer to the question of how to deal with asset price inflation: obviously monetary policy cannot remain indifferent when asset prices seem to be moving too fast, but it cannot be directed solely at maintaining the right level of asset prices. One approach to dealing with asset prices that appear to be moving away from fundamental values is to use regulations to reduce the availability of credit for purchasing assets.

The recent financial system crises, as well as the process of deregulation, have sparked a healthy and continuing reexamination of measures to prevent crises and how to respond to them when they do occur. Better regulation and supervision are key to prevention, and central bank cooperation has gone a long way toward improving both. Regulation includes licensing requirements and the imposition of prudential standards. Supervision requires the monitoring and enforcement of these standards, a task that is rarely as easy as it sounds.

Given the complexity and the pace of innovation in modern financial markets, as well as the scope for, and difficulty of, detecting fraud or simply mismanagement, effective monitoring requires a constant process of probing, analyzing, and questioning

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banks' activities and data. The direct resource costs can be large, and staff with the appropriate qualifications scarce, even in industrial countries, but especially in developing countries. The burden can be eased somewhat through firm bank entry policies, but the supervisory challenge remains. Supervisory authorities continue to seek better ways to monitor performance, some relying on markets, investors, and depositors to do part of the monitoring. It is fair to say, though, that we should never be confident that supervisory systems are adequate; this is an area where the IMF's standard caution—complacency should be avoided—is always appropriate.

Payment risks

In seeking to prevent crises, central banks have also become increasingly concerned with the risks that arise in the payment system. Periodic net settlement systems may allow scope for major intraday interbank exposures to go unmanaged, and even unrecognized. This is a potentially important channel through which difficulties in one financial institution can spread quickly to others through a payment default. The problem can be addressed in part by strengthening the legal framework that applies when it becomes necessary to unwind net payments.

More fundamentally, systemic payment risk can be contained either by strengthening risk management in net systems or by introducing a real-time gross settlement (RTGS) system, at least for large transactions. To the extent that the central bank provides intraday credit to prevent gridlock in an RTGS system, the central bank itself may have to manage extremely large exposures. Issues of pricing, collateralization, and credit limits become pressing, as reflected in recent changes under the Fedwire settlement system in the United States, for example.

At one time, deposit insurance was seen as a critical element in preventing financial crises. This view was based on a diagnosis that self-fulfilling bank runs were an important propagating mechanism in financial crises. Post–World War II experience has drawn increased attention to the moral hazards of explicit deposit insurance and the insurance implicit in the "too big to fail" doctrine. Accordingly, formal deposit insurance is generally confined to individual depositors and applies only up to a maximum account balance. Implicit insurance coverage for other deposits remains, however, and there have been very few major bank failures in which depositors have lost large sums of money—though depositors in some transition economies have suffered relatively serious losses.

Banking supervision

There is an important global perspective to the setting of prudential standards, to supervision, and to strengthening payment systems. Differences among regulatory and insurance frameworks can lead to arbitrage between systems (for instance, as in the development of the Eurodollar market and offshore banking centers). International harmonization and supervisory coordination have become increasingly important as political boundaries have become less relevant to financial sector business, global banking organizations have proliferated, and economic integration has proceeded apace. In the payment area, too, the need for harmonization and coordination has increased, not least because of the very large risks involved in foreign exchange settlement arrangements.

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Major progress in coordination and harmonization of bank supervision has been achieved through the Basle Committee and Concordat. The Basle standards are now applied in nearly 100 countries. At the same time, there have been parallel coordination efforts with supervisors of offshore banking centers and, because of the growing recognition of the increasingly fuzzy distinctions between banks and other financial institutions, with the International Organization of Securities Commissions (IOSCO) and insurance supervisors. Coordination has further to go in these areas.

Gaps and differences among supervisory systems nonetheless remain, as has been demonstrated in several recent, well-publicized cases. The need to deepen and, especially, to broaden international supervisory coordination is seen by many as one of the biggest immediate challenges for central banks. The IMF is willing to contribute, within the constraints of its limited resources, to furthering this process.

Lender of last resort

When crisis prevention fails, the central bank, as lender of last resort (LLR), has an obligation to help deal with the consequences, at minimum current and future cost. Dealing with significant failures of individual institutions or with groups of very fragile institutions requires a well-developed strategy. Intervention, in the form of closure, merger, or some form of rehabilitation, needs to be decisive and determined. Owners and managers of the failed institutions need to incur substantial losses. At the same time, the strategy should seek to ensure that the central bank is not drawn unnecessarily into lender-of-last-resort financing of troubled banks and exposure to major credit risks. Rather, the costs of any publicly funded financial support should be borne and recognized explicitly, generally in the budget. These expenses may become very large when much of the banking system is affected. Generally, the budget is charged with the interest costs on the resources put into recapitalizing and restructuring financial institutions. The issue of limiting monetization may also arise when the central bank directly or indirectly funds payouts made through formal deposit insurance schemes.

In discussing the central bank's role as lender of last resort, it is important to distinguish between a system-wide crisis and an individual bank problem. In the systemic case, no one other than the central bank can provide additional base money quickly in the event of a confidence-related shock to the demand for it. In this context, LLR lending does not conflict with monetary policy objectives, since it is a response to a shift in the demand for base money. Here all Bagehot's maxims apply.

Where individual bank problems are the issue, there is no presumption that access to the central bank's LLR facility is appropriate. If access is allowed, it should be well

collateralized and provided only at a penal cost, and the monetary injection should be offset through other operations. In practice, of course, the challenge for central bankers is to identify whether or not a problem is, or is likely to become, a systemic one and, if so, to judge how much overall liquidity conditions need to be eased and for how long. This problem was evident after the 1987 stock market crash.

Conclusion

While important progress has been—and will continue to be—made in dealing with some of the problems that have caused financial system crises in the recent past, some underlying tensions and trade-offs need to be recognized.

First, the benefits of strengthened supervision need to be weighed against the costs. For instance, increasing capital requirements or restricting entry is likely to increase the customer's cost of borrowing. Not surprisingly, supervisors sometimes take different views about where the appropriate balance lies—witness the different views about the need for more direct regulation of derivatives transactions. These differences can complicate the task of international coordination.

Second, there is the related issue of incentive compatibility. A beneficial regulatory framework needs to strengthen market incentives in a way that contributes to achieving the objectives of the regulations, rather than inadvertently creating perverse incentives. The issue is how to enlist market discipline in support of the objectives of prudential policy. For example, the recent introduction of risk-adjusted deposit insurance premiums in the United States reflects a recognition of the perverse incentive problems that the previous framework had created.

The moral hazard problem is a key aspect of incentive compatibility. This problem may arise even in countries without formal deposit insurance. The "too big to fail" presumption often lurks in the background—and there is no question that large failures can create extremely difficult situations for governments and central banks. Hence the supervisor's prayer: let there be failures, but let them be small.

As a matter of principle, and in order to reduce moral hazard, owners and managers of large, as well as small, banks need to bear substantial costs when an institution fails. But policy and practice differ on the extent to which depositors/investors should also bear costs. Supervisors must be guided, and be seen and believed to be guided, by the principle of maintaining the integrity of the system as a whole rather than that of individual institutions.

Neither of these two issues—the balancing of the costs and benefits of supervision and regulation, and incentive compatibility—can in any sense be solved. Rather, the central bank has to take them into account in each situation and as the economy evolves. No doubt, solutions such as narrow banking will continue to be proposed. But the narrow banking solution will not work, for the incentive for each narrow bank will be to shade at the edges and become a real bank. Further, it is not credible to maintain that the central bank will fail to come to the rescue of nonbank intermediaries if their failure threatens major financial disruption.

Financial innovation by the private sector, designed in part to avoid regulations, will not cease. Nor will the political pressures that emerge in any situation where so much is at stake as in the financial system. Thus, central bankers can rest assured of an interesting life in which they will continue to have to deal not only with the challenge of fighting inflation but also with the challenges to the health of the financial system created by financial innovation, incentive incompatibility, political pressure, fraud, mismanagement, and investor overexuberance, all within the context of a rapidly globalizing economy. F&D

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This article is the second in a two-part series by the author on challenges facing central banks. The first article in the series, "Maintaining Price Stability," was published in the December 1996 issue of Finance & Development. *Both articles are based on the author's paper that was prepared for the 25th Anniversary Symposium of the Monetary Authority of Singapore, held on May 10, 1996.*

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A postscript on inflation targets

In the first article in this series, "Maintaining Price Stability," published in the December 1996 issue of *Finance & Development*, I discussed inflation targets, concluding with a statement that I advocate *inter alia* a target rate of 1–3 percent. From the context, it should have been clear that this referred to countries that have already attained low single-digit inflation rates.

For countries with higher inflation rates, in the double digits or even higher, the *eventual* goal should be to attain an inflation rate similar to those of the leading industrialized countries. When a country has a very high inflation rate, much above 50 percent per annum, it will typically be necessary to undertake a comprehensive stabilization program to reduce the inflation rate, and in this context the goal should be to achieve a major and rapid reduction in inflation.

If inflation has been long persistent and is in the moderate range, generally defined as 10–40 percent per annum, it will often be advisable to aim to reach the ultimate target inflation range only gradually. The precise target range, including its width, and the rate at which it should be approached, would vary, depending on country characteristics. However, I believe that the costs of even moderate inflations are sufficiently high that countries should not accept double-digit or high single-digit rates, but rather keep aiming to reduce inflation until they reach the target low inflation range. *Stanley Fischer*