Financial stability and Central Bank tasks

Since the financial system operates as a channel for capital and risk-spreading in the economy, its efficient and reliable functioning is vital. To create the most effective conditions for financial system operation, the government has established a general legislative framework and pursues responsible economic policies. It has also assigned separate tasks to the Central Bank and Financial Supervisory Authority (FME) in order to contribute to the soundness of the financial system. Broadly speaking, the Central Bank is assigned the tasks of promoting the efficiency and safety of the financial system as a whole and in a macroeconomic context – namely, financial stability. The FME has a regulatory role to ensure that financial activities conform with the law, regulations, rules and agreements, and a supervisory role. Both institutions contribute to financial stability and effective cooperation between them is essential. But what does financial stability mean and how does the Central Bank strive to perform its role in this area?

Financial stability

Recent Central Bank of Iceland financial stability reports have cited Andrew Crockett's definition that financial stability broadly hinges upon the stability of the key institutions and markets that make up the financial system. "This requires (1) that the key institutions in the financial system are stable, in that there is a high degree of confidence that they continue to meet their contractual obligations without interruption or outside assistance; and (2) that the key markets are stable, in that participants can confidently transact in them at prices that reflect the fundamental forces and do not vary substantially over short periods when there have been no changes in the fundamentals."[1] Crockett also points to the twin financial stability tasks of addressing both systemic risk and systemic resiliency. Risks will always be present, although they can be contained to a certain extent. Insofar as risks cannot be avoided, financial stability tasks must concentrate on strengthening systemic resilience.

No single definition of financial stability has gained international acceptance. Research in this field is rapidly evolving, as can be seen from the increasing amount of literature on the topic, and a number of different approaches are possible. Economists, for example, emphasise the distinctive character of the financial markets, including the prevalence of asymmetric information. George A. Akerlof, Michael Spence and Joseph E. Stiglitz earned the Nobel Prize in 2001 for their analysis of markets with asymmetric information, which is vital for an understanding of financial markets and the roots of financial crises. Asymmetric information leads to adverse selection and moral hazard. Moreover, information is not only asymmetric but also imperfect and expensive to acquire, and future uncertainties will always exist.

In accordance with this economic approach, until recently financial stability was generally defined in terms of its antitheses, i.e. instability or crises. Financial crises have a long history and they have been more common than is generally thought. The most immediate

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1. Crockett, Andrew (1997), Why is Financial Stability a Goal of Public Policy?, in *Maintaining Financial Stability in a Global Economy*, a Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming.

examples for Iceland are the banking and currency crises that struck neighbouring countries Finland, Norway and Sweden after 1990.[2] Shocks resulted in a large-scale official bailout and the partial nationalisation of the banks. The direct cost to the public sector caused by the banking crisis in Finland was equivalent to 8-10% of GDP, and in Norway and Sweden it amounted to 4-5%. In the US, the savings bank crisis in the 1980s cost the equivalent of 5-7% of GDP. In many instances state bailouts have been even greater, over and above a substantial negative impact on economic growth. More recent examples that may be cited include the crises in Asia and Russia, the US hedge fund crisis of autumn 1998, liquidity problems among important economies such as Argentina and asset bubbles.

A financial crisis is the most serious form that financial instability can take. Market failures of this kind have serious consequences, as the above examples show, but so do instabilities that do not actually trigger a crisis. Instabilities heighten uncertainties, hamper the efficiency of the financial system and can subdue investment and economic growth. Every participant in the financial system weighs up the gains and the risks and looks after its own interests, without adequate provision for the interests of the whole. Financial stability therefore has many of the features of a public good. Individual participants do not strive to ensure systemic stability, but rather have an incentive to act as free riders, even though it is in the common interest to safeguard the overall stability of the financial system. Financial crises or instability are a social problem just like pollution, for example, and just as costly.[3]

Increasing efforts have been made to define financial stability directly rather than in terms of what it is not. The International Monetary Fund recently published an interesting paper by Garry J. Schinasi[4] which includes an overview of definitions or descriptions of financial stability by a selected group of officials, central banks and academics. Schinasi proposes his own working definition, taking the approach that it is better "to define financial stability rather than its absence, in part because this is likely to be the more useful 'policy' objective".

Schinasi presents a number of key principles for defining financial stability. In short, this definition needs to be a broad concept; imply not only that finance adequately fulfils its role in allocating resources and risks but also that the systems of payment throughout the economy function smoothly; relate to the ability of the financial system to limit, contain and deal with the emergence of imbalances before they constitute a threat to itself or economic processes; be couched in terms of the potential consequences for the real economy; and be based on the principle that financial stability be thought of as

2. See e.g. Ingves, Stefan (2002), *The Nordic Banking Crisis from an International Perspective*, Speech at a Seminar on Financial Crisis, Oslo, September 2002, www@imf.org.
3. Haldane, Andrew (2005), A framework for financial stability, *Central Banking*, February 2005.
4. Schinasi, Garry J. (2004), Defining Financial Stability, *Working Paper 04/187*, IMF.

occurring along a continuum. On these assumptions, Schinasi presents his definition of financial stability: "A financial system is in a range of stability whenever it is capable of facilitating (rather than impeding) the performance of an economy, and of dissipating financial imbalances that arise endogenously or as a result of significant adverse and unanticipated events."

There will never be universal agreement on the best definition of financial stability and it is natural for such a definition to change in pace with theoretical advances. Any definition ought to be precise, highlight the key points of financial stability, be easy to understand and have practical application. An example is the following definition adopted by Norges Bank, the Central Bank of Norway: "Financial stability means that the financial system is robust to disturbances in the economy, so that it is able to mediate financing, carry out payments and redistribute risk in a satisfactory manner." The Central Bank of Iceland considers it useful to present such a statement of its own, which is printed on page 2 together with the Bank's aims in publishing *Financial Stability*. Definitions of financial stability will change over the course of time, and so will the Central Bank's terms of reference. What is crucial is how the Central Bank formulates its policy in accordance with the role assigned to it, and how it works towards furthering it.

The Central Bank's role in financial stability

Act No. 36/2001 on the Central Bank of Iceland states that the Central Bank shall promote an efficient and safe financial system, including payment systems domestically and with foreign countries. Particular mention was made of this task in Article 4 of the Act since it is of major importance in central banking and reflects the growing focus given by most central banks to promoting financial soundness. The Central Bank of Iceland sets rules on the operation of interbank markets and certain prudential rules, may act as a lender of last resort and is accountable for its actions. Through its measures, publications, professional opinions, meetings and personal contact the Bank seeks to exert an influence on parties that can promote an efficient and sound financial system. Efforts include developing and strengthening financial system infrastructure and contingencies. These tasks were specifically incorporated into the Central Bank of Iceland's organisational structure at the beginning of 2001 with the establishment of a new department, the Financial Stability Department, which is directly assigned the task of furthering the Bank's financial stability objectives.

As authorised by law, the Central Bank of Iceland sets prudential regulations on the liquidity and foreign exchange balance of credit institutions. On the basis of its rules to this effect, the Bank compiles reports enabling it to monitor changes in the liquidity position of individual institutions and the system as a whole. The Bank also specifically monitors foreign borrowing by the banks, on the basis of information including loan maturities.

Among the special recourses made available to the Central Bank when the Act was passed by parliament in spring 2001 is a provision

permitting the Bank to act as a lender of last resort. This states that, in special circumstances when the Central Bank deems it necessary in order to protect the safety of the domestic financial system, the Bank may issue guarantees to credit institutions which are in liquidity difficulties or grant loans to them outside its regular business framework, on special terms and against other collateral than is customary or against other conditions laid down by the Bank. This means that, when the Bank regards its assistance as necessary in order to prevent fears about the safety of the financial system or the possibility that difficulties on the part of a single institution would lead to a run on the banks, it can intervene to carry that institution temporarily through the troubles it may have encountered. Particular mention was made that this applied to liquidity problems of individual institutions. This means that the Central Bank will not provide assistance in the form of special facilities to boost the capital position of institutions which run into difficulties.

Central Bank assistance may involve issuing guarantees to the relevant credit institutions or granting loans to them on special terms, conceivably against other collateral than the Bank customarily requires in its transactions with credit institutions, or imposing other conditions. The Bank could feasibly insist on reforms to the institution's activities as a condition for granting such assistance, for example a change of executive management.

It can prove difficult to distinguish between a liquidity problem and wider-reaching ones when an institution experiences difficulties of the kind addressed by this provision. The Central Bank will naturally engage in close cooperation and consultation with the FME on solving any such problems which may arise. The Central Bank has organised contingency plans and held exercises for meeting conditions in which it would probably need to provide special facilities.

Cross-border banking operations have become commonplace. Nordea Bank operates in four of the Nordic countries and farther afield – Kaupthing Bank operates in all five. In light of this development, the five Nordic central banks signed a Memorandum of Understanding (MoU) in Iceland in 2003 on financial crisis management. The MoU is applicable when a severe problem occurs in a bank which is domiciled in a Nordic country and has cross-border establishments in one or more other Nordic countries. Comparable work is in progress within the European Union.

Payment intermediation is an important element of all financial systems, i.e. the transfer of payments from the payer to the payee through the intermediacy of financial institutions and between the institutions themselves, and how these are settled. Although payment and settlement systems have a low public profile, it is vital for them to be technically effective and meet the utmost requirements for reliability and efficiency. Flaws in payment and settlement systems could have serious consequences, and furthermore efficient payment intermediation is one of the preconditions for smooth implementation of the Central Bank's monetary measures. The Central Bank plays a key role in Icelandic payment and settlement systems and has promoted extensive reforms with the aim of enhancing their soundness

and ensuring that they fulfil international standards for functionality and safety. The FME and the Central Bank have made an agreement on supervision and oversight of payment and settlement systems, specifying their respective duties.

The main tasks of the Central Bank and FME do not overlap except insofar as both institutions monitor and seek to promote the soundness of the Icelandic financial system in their respective ways. Cooperation between them is governed by an agreement which has been published on both institutions' websites. The specified main aims of the agreement include ensuring coordinated responses by the FME and Central Bank to conceivable systemic risks in financial markets.