Determinants of Financial Stability

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The subject raises a huge interest in international circles, be it research groups, financial institutions or public decision makers due to market globalization and integration which trigger the risks that are spread from one market to the other through intensive financial flows.
The definition of financial stability is controversial. Therefore we endeavor to select the most prominent views concerning this subject given its importance in modern economies. Further the most important macroeconomic determinants of financial stability are described as well as the requirements to fulfill this objective.

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1. Financial Stability defined

The definition of financial stability is controversial. It generally means the *joint stability of key financial institutions operating within financial markets and the stability of those markets*. For the financial institutions this means that they are sound, i.e. they have sufficient capital to absorb normal and abnormal losses, and have sufficient liquidity to manage operations and volatility.

The concept of financial stability is most often thought of in terms of avoiding financial crises but also managing systemic financial risk. If the latter is managed reasonably well by market participants, through their private risk management and by the authorities through its banking supervision and market surveillance, then systemic financial crises will most likely not occur.

At this point, it is necessary to define the systemic financial risk. It is the risk that an event will trigger a loss of economic value or confidence in a substantial portion of the financial system that is serious enough to have significant adverse effects on the real economy.

Systemic risk events can be sudden and unexpected, or the likelihood of their occurrence can build up through time in the absence of appropriate policy responses. The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values.

Two main assumptions underlie this definition. First, economic shocks may become systemic because of the existence of negative externalities associated with severe disruptions in the financial system. If there were no negative externalities, there would be, arguably, no role for public policy. In all but the most highly concentrated financial systems, systemic risk is normally associated with a contagious loss of value or confidence that spreads to parts of the financial system well beyond the original location of the precipitating shock. In a very highly concentrated financial system the collapse of a single firm or market may be sufficient to qualify as a systemic event. Second, systemic financial events must be very likely to induce undesirable real effects, such as substantial reductions in output and employment, in the absence of appropriate policy responses. The study notes that this definition encompasses much of what is in the literature but it is stricter in two respects. One is that the negative externalities of a systemic event extend into the real economy. They are not confined into the financial system. The second is that this extension into the real economy occurs with relatively high probability. The emphasis on real effects reflects the view that it is the output of real goods and services and the accompanying employment implications that are the primary concern of economic policymakers.

In answering what is financial stability, it is useful to have a working definition of a financial crisis: *A financial crisis is fueled by fears that the means of payment will be unobtainable at any price and, in a fractional reserve banking system leads to a scramble for high powered money*. It is precipitated by actions of the public that suddenly squeeze the reserves of the banking systems…The essence of a financial crisis is that it is short lived, ending with a slackening of the public's demand for additional currency.

Financial stability of an economy depends on two fundamental sets of factors. The first comprises the macroeconomic and structural *conditions in the real economy* bearing on financial decisions and which form the environment within which the financial system operates. The second is the *robustness* of the financial system itself, comprising the financial markets, institutions, and arrangements through which financial transactions are carried out. Major instabilities or distortions in the real economy almost inevitably pose risks to financial stability, however robust the financial system. Nevertheless, a robust financial system can lower the risk that problematic real economic conditions will lead to financial crisis as well as reduce the damage from a crisis if it occurs. Financial stability depends not only on having the requisite institutions and other capabilities; there must also be sufficient political and social consensus supporting the measures needed to establish and maintain that stability.

A robust financial system is essentially one that meets the "test of markets", insofar as it remains stable and efficient under a wide range of market conditions and circumstances. Robust financial systems can take a number of specific forms but all have three basic attributes.

First, a robust system is *flexible* in that it continues to function efficiently in allocating finance in accordance with underlying economic fundamentals under a full range of economic circumstances - in particular when those circumstances are changing rapidly. Secondly, the system is *resilient* in the sense that markets continue to function and payments are carried out reliably and expeditiously in the face of economic disturbances. And thirdly, a robust system is *internally stable* in the sense that it does not itself generate major financial shocks, or magnify external shocks, that can lead to financial crisis, for example, when banks continue to lend for the purpose of real estate even when prices have gone beyond economically justifiable levels in the expectation that they will be bailed out if a contraction occurs.

The degree to which a financial system possesses the qualities needed for robustness depends largely on how well it performs three basic functions: maintaining appropriate *incentives* for financial actors; generating the available *information* bearing on financial decisions; and providing the necessary *capabilities* for institutions and individuals to respond effectively to market incentives and utilise information.

Appropriate incentives are essential to ensure that investors, creditors, owners and managers, in the pursuit of their private interests, pay heed to the social consequences of their actions and take necessary precautions in the face of risk. For this to be the case, private actors need to reap the full gains, and bear the full costs and risks, of their financial decisions; and the gains, costs and risks to private actors need to be in line with those available to the economy as a whole. Markets must also be able to exercise adequate discipline, and stakeholders must be able to reward and penalise the managers of financial institutions for their successes and failures.

Timely access to relevant and reliable information is essential for effective financial decisions, as well as for effective market discipline, corporate governance and supervisory oversight. Robust and efficient financial systems possess means for gathering and disseminating all material information needed by lenders and investors to assess the creditworthiness of their counterparties, by stakeholders to monitor the performance of those to whom they have delegated responsibility, and by supervisory authorities to exercise prudential oversight.

To respond effectively to incentives and information, individuals and institutions also need to possess the *capabilities to implement their financial* *decisions*. There needs to be a robust infrastructure to ensure that transactions can be carried out reliably and in a timely manner and are enforceable; that information is disseminated adequately; and that there is a sufficient array of markets and financial vehicles to allow actors to allocate their resources effectively among alternative uses and over time, and to diversify risks. In addition, financial actors need to be free from undue regulatory or other legal restrictions on their ability to carry out transactions.

We will further consider key requirements for promoting financial stability. These requirements can be regarded as end-point objectives that efforts to improve financial robustness should seek to attain over time, rather than as a set of characteristics that can be attained immediately or which currently are fully present in any financial system. The discussion begins with conditions in the real economy and then delineates the key elements of a robust financial system under three headings: *infrastructure, market functioning and regulatory and prudential oversight.* Two points concerning the discussion should be emphasised:

1. No single step or narrow group of steps can be sufficient to ensure a robust financial system. Robustness is a function not only of the individual factors themselves but of their interaction; thus improvements in one area typically require complementary measures in other areas if their benefits are to be fully realised.

2. The specific institutional arrangements needed to ensure robustness will change as markets and the economic environment evolve; thus the ability of the financial system, including regulatory and supervisory arrangements, to adapt to economic change is essential to maintaining financial robustness.

2. Prerequisites for a sound financial system

Conditions in the real economy, macroeconomic and structural, provide the basic signals to which the financial system responds. Financial stability depends critically upon the degree to which these conditions promote the following objectives. The first is to provide as much predictability as possible in economic outcomes by minimising fluctuations in real activity and avoiding unnecessary swings in asset prices and resource allocation. Such predictability reduces, although it cannot entirely eliminate, the risk of extensive financial "mistakes" that lead to financial problems. Predictability requires the avoidance of unsustainable debt loads or financial imbalances whose reversal can lead to sudden large shifts in asset prices and to instability in the real economy. The second objective is to generate appropriate incentives for the allocation of investment resources, across sectors and over time, in a socially efficient manner. And the third is to promote features of the financial system that strengthen its robustness. Macroeconomic and structural conditions are important not only individually, but also because *their effects are mutually reinforcing*. Realisation of the full benefits of stable macroeconomic conditions requires sound structural conditions; and certain structural imperfections can greatly magnify the financial risks arising from unstable macroeconomic conditions.

a. Macroeconomic requirements

The following macroeconomic requirements are crucial for the maintenance of financial stability:

1. Macroeconomic policies should seek sustainable growth in line with the economy's potential, and avoid "stop and go" growth since it creates widespread uncertainty and risks of pervasive financial reverses.

2. Achieving and maintaining price stability is of equal importance to sustain incentives to enter into long-term contracts and to minimise distortions and the uncertainty about relative prices fostered by inflationary environments.

3.Sound public finances are essential: public deficit and debt levels should be sustainable and moderate. Public debt, especially that held externally, must be adequately diversified in terms of currency, maturity and the range of holders. Government pension systems and other public programmes involving future commitments need to be adequately funded and consistent with the economy's capacity to meet the commitments.

3. There must be an adequate level of national saving, private and public, to finance domestic investment needs without unsustainable reliance on foreign borrowing.

4.Macroeconomic policy instruments must be adequate and consistent with the exchange rate regime: monetary authorities need to be free to pursue price stability as their overriding objective; and fiscal authorities must have the capability to control public expenditures and collect adequate revenues.

Given that financial decisions involve commitments extending into the future, *financial stability depends not only upon the present or recent effectiveness of macroeconomic policies but also upon their future credibility*. A high degree of policy credibility helps to minimise volatility in financial market prices and makes it more likely that changes in those prices will be stabilising for the economy as a whole. Credibility is largely derived from past policy performance over a substantial period - which increases the premium on the pursuit of sound policies in the present. And, especially as financial markets develop and become more sophisticated, credibility depends increasingly upon the clarity, transparency and internal consistency of the policy commitments of public authorities.

b. Structural requirements in the real economy

Structural policies should seek to ensure that relative prices are in line with economic fundamentals so that they provide proper financial incentives; and that structural conditions promote the efficient and sustainable allocation of real and financial resources. Sound structural conditions promote the smooth adjustment of prices and quantities to changing economic conditions, and reduce risks that asset values will be impaired by sudden shifts of relative prices that have become misaligned in relation to their long-term fundamental determinants.

Important ingredients of sound structural conditions include:

1. Tax policies that minimise distortions to incentives; tax provisions whose distortionary effects are magnified by inflation should be avoided; tax regimes should be stable and predictable.

2. Efficient, competitive and flexible markets - for products and productive factors such as land, labour and other basic resources - that affect financial incentives. Structural policies affecting the financial sector, further discussed need to ensure its efficient operation, stability and robustness.

c. Institutional infrastructure of financial markets

The availability of information necessary for sound financial decisions, the ability to respond to incentives and the capacity to implement financial transactions efficiently all depend upon the quality of a number of infrastructure building blocks that support effective market functioning. These include the *legal and judicial framework* governing financial markets and operations, the *accounting systems* used to gather and disseminate information, *the payment systems* for executing transactions, and the *infrastructure features of the markets themselves*.

The basic functions of the *legal/juridical framework* in supporting the financial system are:

1. to establishes clearly the rights, responsibilities and liabilities of the parties to financial transactions;

2. to establishes codes that support market forces in maintaining appropriate incentives and adequate information;

3. to provides means to enforce legal obligations and claims efficiently.

In order to accomplish these aims, the legal framework needs to include adequate contract, corporate, bankruptcy and private property laws. A basic requirement of any legal code is up-to-date contract law that clearly defines the contractual rights and responsibilities of all agents involved in loans and in the purchase, sale and holding of the full range of available financial instruments. Among the legal provisions required are those governing obligations to meet contractual payments, the definition and consequences of non-payment, requirements entailed by covenants and other conditions placed on the borrower, and custody of collateral. Responsibilities and liabilities of financial agents, stakeholders and managers of financial institutions need to be clearly defined, so that they are held accountable for their conduct. As far as possible, legal provisions governing financial activity need to be "rule-based" and transparent. For example, conditions governing the exercise of contingent provisions, such as call options, and the taking possession of collateral, need to be objective so that they can be readily identified by all parties. Legal provisions should also be formulated in a sufficiently flexible fashion to allow their extension to new instruments and activities as they emerge - while recognising that changes in laws will be necessary when more fundamental market changes occur.

Since individual actors often have an incentive to withhold private information, legal codes need to mandate disclosure of facts directly material to counterparties, stakeholders and other interested parties if effective market discipline is to be maintained. Other activities that take undue advantage of information disparities or which abuse fiduciary responsibilities, such as self-dealing or insider trading also need to be legally discouraged.

Of particular importance to preserving appropriate incentives are standards governing the entry of financial firms together with bankruptcy codes and other provisions relating to exit. Well-designed bankruptcy codes reduce uncertainty by specifying ex ante rules governing the distribution of unpaid obligations in the event of failure, and provide a necessary "breathing space" to make provision for an orderly disposition of the failing entity, or to allow the continued operation of an entity whose value as a going concern exceeds its break-up value. It is very important that such provisions maintain stakeholders' liability, up to the limit of their original commitment, for losses from failing institutions as well as management accountability so that moral hazard incentives are contained. Codes should be such that bankruptcy is seen as a last resort by institutions in financial difficulties to avoid undermining the fundamental principle that debts must be repaid on time and in full. To balance these considerations effectively, bankruptcy authorities need to have adequate legal and administrative authority to replace managements, to reorganise failing institutions, and to develop and, if necessary, impose formulas for distributing assets.

The effectiveness of the legal framework also depends critically upon the quality of enforcement of its provisions. Judicial remedies in the event of non-compliance with contracts need to be efficient and expeditious: judicial procedures should not be so costly that they discourage companies from acting to enforce their contracts. It is particularly important that remedies are obtainable in a time-frame that is relevant to the financial transaction involved: for example, unless creditors are able to gain possession of collateral rapidly in the event of non-payment, or to take action quickly when covenants are violated, the provisions are effectively voided in economic terms. Legal procedures for enforcement also need to be objective and honest so that outcomes of disputes are as predictable as possible on the basis of objective criteria. There should be laws against illicit financial activities, in particular money laundering, and they should be vigorously enforced since such activities, by undermining the reputation of individual financial entities, can impair confidence in the financial system as a whole.

Two other specific priorities are improvements in the *transparency and efficiency of the judicial mechanisms* to enforce financial agreements; and ensuring that *effective means exist to take possession of collateral*. Difficulties encountered in many emerging markets in obtaining reliable remedies in case of non-compliance (because of undue delays, overly convoluted administrative procedures and the inability to predict how applicable laws will be interpreted in practice) were cited by many of the respondents to surveys of participants in major financial centres. Improvements in this area would help particularly in improving emerging market economies' access to external financial markets and in encouraging the transfer of skills and financial technology via direct investment. All economies periodically face the task of *revising and updating legal codes to reflect new market realities*. Transition economies face a particularly great challenge in developing legal codes suitable to a market environment, given their heritage of extensive state involvement in economic decisions. In this respect, frameworks based on industrial country models have proved quite useful as a starting-point but must still be adapted to the particular financial systems of transition economies and altered as those systems evolve.

Accounting systems are central to the provision of the information needed by the creditors, borrowers, owners, managers and others with an actual or potential stake in an enterprise to make reasonable assessments of the effectiveness of the enterprise's operations and to assess its future prospects. High-quality accounting systems are essential to ensure the transparency of operations needed for effective internal governance and market discipline. Effective accounting systems embody four basic quality standards.

First, the information provided is numerically and factually *accurate*; secondly, it is *relevant and transparent* in that individual items correspond correctly to the underlying condition being reported; thirdly, the information is *comprehensive* in covering all material activities and aspects of an enterprise's operations that bear on its present and future financial condition; and fourthly, the information needs to be sufficiently *timely and regularly provided* to be of use when decisions are made.

A more general principle is that accounting measures should provide a realistic picture of the *true economic gains and losses*. Methods used to value assets need to take realistic account of their likely value when liquidated or redeemed, in the light of the portfolio strategies of the institution as well as unforeseen contingencies it may encounter. Valuation at historical cost of loans or other assets, for which there is no satisfactory organised market, on the condition that adequate provisions are made for non-performance or losses, can provide a reasonable method of accounting for the true economic value of assets that are held to maturity. On the other hand, marking marketable assets to market value generally provides a more reliable indication of their true economic value, but only if the markets are sufficiently developed and efficient to provide reliable guides as to prospective asset-sale prices.

Essential elements of accounting procedures applying to banking and other financial institutions are standards governing:

1. Classification and reporting of asset quality, including realistic valuation and strict criteria for recognising bad loans;

2. Timely and prudent procedures for provisioning and strict quality standards for the components of capital;

3. Accurate measurement and reporting of loan concentrations, including systems to detect excessive lending to related parties or over-concentrations in particular sectors or instruments;

4. Relevant measures of profitability and other aggregate indicators of the overall financial position;

5. Effective systems to assess individual risks as well as risks to the aggregate portfolio under various contingencies;

6. Consolidated reporting including all relevant affiliated entities whose condition directly affects the financial position of the parent;

7. Adequate reporting of contingent and below-the-line liabilities, such as unfunded pension liabilities and guarantees for affiliates.

These procedures and rules are essential to avoid the concealing of serious asset quality or other financial problems in financial institutions from supervisors and stakeholders. *Auditing mechanisms* are essential to ensure that accounting norms are effectively applied and maintained and to monitor the quality of internal control procedures. Both internal and external audits are vital complements to assessment of financial institutions by supervisory authorities. Internal audits on an ongoing basis enable problems to be recognised before they are able to impair the financial soundness of an institution. External audits on the basis of internationally acceptable standards by independent qualified private entities are important in ensuring the objectivity and integrity of internal control procedures and the accuracy and comprehensiveness of information disclosed to external parties. To ensure their objectivity and credibility, external auditors need to be legally accountable for the competence and integrity of their examinations. There should be comprehensive laws setting out the responsibilities and obligations of external auditors, and independent auditing should be required at least for public companies and licensed financial institutions. However, internal management bears the first and primary responsibility for ensuring that internal audits are effectively conducted and that information disclosed to external auditors and the public is adequate.

The *development* of accounting standards so as to provide accurate, timely and internationally comparable information is a key priority for improving the robustness of financial systems in emerging market economies, particularly given the role that deficiencies in accounting systems have played in past banking crises.17 It is very important that national accounting standards be of high quality and be rigorously interpreted and applied. Harmonisation of private accounting standards with those employed by supervisors is also important in order to reduce the costs to private institutions of complying with regulatory/supervisory requirements.

In many emerging economies, auditors, management and supervisory authorities face considerable difficulties in adequately measuring the value of individual instruments and

Therefore of an institution's portfolio as a whole. These difficulties have considerably hampered the ability of managements to assess adequately their institutions' financial status and to make changes in investment priorities when needed; also hampered are market discipline and the ability of regulators to recognise developing problems before they become serious. While due partly to deficiencies in accounting standards, this difficulty is aggravated by underdeveloped markets, which make it hard to predict liquidation values; and where markets are better developed, by a lack of price data on which to base assessments of loan and other asset values.

This problem also raises a broader issue *about gaps and deficiencies in publicly available data*, particularly from national authorities, on aggregate financial indicators, conditions in the real economy and government policies. A lack of such basic data, for example timely figures on the international reserves held by the government, has been an important factor limiting the ability of stakeholders and other interested parties, in particular foreign investors and official institutions, to effectively monitor the economic and financial condition of countries that are major international borrowers.

3. Regulation and supervision of financial systems

Official oversight of the financial system encompasses financial regulation, including the formulation and enforcement of rules and standards governing financial behaviour as well as the ongoing supervision of individual institutions. Financial regulation and supervision play an essential role in fostering financial robustness. They should seek to support and enhance market functioning, rather than to displace it, by establishing basic "rules of the game" and seeing that they are observed. Effective and adaptable regulatory/supervisory structures are critical in all economies. Special vigilance and skill are needed by the regulatory/supervisory authorities to contain the risks arising when the financial system is undergoing rapid and extensive change.

A fundamental guiding principle in the design of all regulatory/supervisory arrangements is that they should seek to support and enhance market functioning, rather than to displace markets. Where financial systems are less developed, a key objective of policy is to reduce the need for regulation in the future by improving the quality of private market forces. The historical experience of industrial countries suggests that the emphasis in regulatory and supervisory approaches shifts as markets liberalise from explicit limits or other rules towards primary reliance on guidelines, supervisory assessments and incentives for sound business behaviour on the part of owners, stakeholders and management.

Apart from the specific responsibilities and objectives noted below, regulatory/supervisory authorities collectively need to pursue the following broader objectives:

1. Define clearly the types of institutions subject to regulation and oversight along with the jurisdiction of each regulatory/supervisory agency for those institutions.

2. Promote the reliability, effectiveness and integrity of the market infrastructure, in particular payments and transactions systems.

3. Foster efficient operation and competition in the financial system. The specific forms taken by regulation and supervision in any particular country are necessarily shaped by individual circumstances, particularly the state of the key features described in earlier sections. Typically, there will be several regulatory/supervisory agencies, with authorities responsible for banks institutionally distinct from those responsible for other major classes of financial institution or for securities markets.

Banking and other authorities charged with overseeing financial institutions have three major areas of responsibility: licensing of new entrants and authorisation for new or expanded activities by existing entities; ongoing supervision of the financial institutions; and remedial correction of problems arising in institutions that are failing, or at risk of failing. To carry out its mandate effectively, each official agency must have powers and responsibilities that are clearly defined and of sufficient scope to accomplish its mission, appropriate standards and enforcement mechanisms, and adequate human and other resources.

There needs to be close coordination and exchange of necessary information among banking, securities market and other regulatory/supervisory authorities, with suitable protection of such information where appropriate.

A clear framework defining responsibilities, objectives and operational independence is an essential foundation for effective regulation and supervision. Ensuring, and if necessary strengthening, the independence of supervisors and regulators is especially important when there has been extensive government involvement in the financial system or when financial institutions are closely allied to large and politically influential commercial interests. At the same time, supervisors and regulators need to report regularly on the general considerations shaping their policies if they are to maintain their credibility with the market and the general public.

In order for supervisors and regulators to exercise their powers and responsibilities in a coherent fashion, *they need a comprehensive set of prudential norms and standards*. In the absence of such criteria, supervision is likely to be haphazard, idiosyncratic and more vulnerable to pressures for exceptions and exemptions. The norms and standards need to be objective, internally consistent, transparent and well-understood by those to whom they are applied; such norms need to clearly define behaviour that is not permitted, as well as the nature and treatment of exceptional or "suspect" conditions, such as exposures that, while permissible, carry special risk or otherwise warrant attention. Regulatory norms and standards must be relevant and consistent with prevailing conditions in the country in which they are applied. However *it is highly desirable that they be of high quality and shaped by certain core principles* for at least four reasons: first, to assure market participants, including foreign stakeholders, that sound financial practices are being applied, thereby increasing market confidence in the country's overall financial health; secondly, to help promote a level playing-field and fair competition among institutions of a similar type; thirdly, to prevent countries adhering to rigorous financial practices from being unduly penalised by "regulatory" competition from jurisdictions with overly lax regulatory standards; and fourthly, to make effective use of the experience and expertise of the international supervisory community in formulating the principles. Norms and standards can play this role only if effective means exist for their *enforcement*. All supervisory authorities need to have access to comprehensive, consistent, reliable and timely information on the activities of the financial institutions they oversee, including those of home or foreign affiliates. Supervisors should have sufficient independence and authority to be able to impose penalties if prudential regulations are not met. Depending on the institutions supervised, possible penalties include: fines; the removal of management in cases of unsafe or unsound banking practices; and constraints on the institution's permitted activities, including, in extreme cases, closure.

The formulation of policies and standards and their implementation and enforcement also require that regulatory/supervisory authorities *have adequate financial and human resources*. Financial crises (including those of the US savings and loan industry) have not been prevented in part because supervisors were either too understaffed or otherwise unable to detect problems arising from the changing strategies of the financial institutions.

Supervisors need to understand the full range of activities undertaken by the institutions they oversee and their knowledge and skills need to be periodically updated to keep abreast of market developments, such as the use of novel instruments and complex portfolio strategies. Supervisors need to have the means to collect, review and analyse supervisory and financial reports from banks on a solo and consolidated basis.

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