The Rt Hon Sir Edward George GBE: Towards a safer banking system

Speech by The Rt Hon Sir Edward George GBE, Governor of the Bank of England, to the Association of Professional Bankers Sri Lanka 12th Anniversary Convention, on 27 August 2000.

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Mr Governor, Ladies and Gentlemen,

It is an immense pleasure, and a very great honour, to have been invited to address this Annual Convention.

The theme of the convention is "Towards a safer banking system". It is a theme which gladdens my heart. The safety of the banking system is fundamental to financial stability in a broader sense. It is vitally important, of course, to you - as professional commercial bankers. But it is vitally important, too, to us, central bankers, because you simply cannot have monetary or broader economic stability, which is a key part of our responsibilities, without stability of the financial system - they go together like love and marriage! And monetary and financial stability are vitally important, too, to our societies at large and to the individuals that make up our societies - they are absolutely necessary, if not in themselves sufficient, conditions for the economic prosperity to which we all aspire.

The question is what can we do - working together - to improve the safety of our banking systems. And you will notice that I emphasise "working together", because while we all clearly have a common interest in that objective, we all - commercial bankers, banking supervisors, central banks and governments - have distinct responsibilities and distinct contributions to make towards bringing it about. And we will not succeed unless we all play our respective parts.

From the programme for your convention I see that most of your working sessions have been concerned with the steps that commercial banks can take to protect themselves against risk in a rapidly changing financial environment and the role of banking supervisors. I should like to start from the other end, as it were, and talk about the role of the authorities more broadly.

I suppose that the most frequent cause of financial instability is macro-economic shocks of one kind or another. Certainly major disturbances can originate within the financial system itself - and that of course in turn can generate macro-economic instability. But my observation is that the causality more often than not runs the other way. From our own experience in the UK, the exaggerated economic boom and bust cycles of the past - at least I hope they are in the past - and fed in some instances by abrupt financial deregulation - have led to a sharp expansion of bank lending in the upswings, the value of which became impaired, amidst a great deal of social as well as economic distress, in the downturns. Consistent macro-economic stability is perhaps the greatest contribution that the authorities everywhere can make to financial stability.

Of course that is easier said than done. While it is true that sharp changes in economic conditions, and asset prices, may be home-grown - often as a result of allowing domestic demand to outstrip the supply-side capacity of the economy to meet that demand, it is also true as we saw very dramatically two or three years ago that instability can be internationally contagious - especially in today's world of financial globalisation.

A great deal of work has gone on internationally over the past few years to improve our understanding of how national authorities can better protect their economies against shocks of this kind. It has resulted in a plethora of internationally agreed standards and codes of best practice ranging from transparency in the conduct of monetary, financial and fiscal policies, through financial regulation and the collection and dissemination of statistics, to various aspects of the financial infrastructure, including the legal and accounting framework, corporate governance arrangements, payments systems and so on. The emphasis now is on implementation and the IMF has the task of encouraging and assisting all of its members to step up their efforts, as best they can given their particular

circumstances, in all of these respects. This is in the member countries' own individual interests, but it is equally in the interest of greater stability of the global economy.

In relation to international capital flows in particular, the answer is not at all to encourage countries to cut themselves off from international finance through the maintenance or imposition of capital controls - though that is not totally excluded. On the contrary the very positive contribution that private capital has made in recent years to the development of many of the emerging market countries is clearly acknowledged, and the objective of orderly and properly sequenced dismantlement of remaining capital controls is generally maintained. The purpose is rather to help to ensure, through greater transparency and improvements to the financial infrastructure, that capital flows to where it can be most productively invested. That should, in turn, help to reduce capital account volatility. At the same time much more attention is being paid to the importance of the maturity and currency composition of national balance sheets, including particularly the maturity and currency composition of the assets and explicit or implied liabilities of the public sector, and also of the banking sector, which can be relatively easily monitored through the supervisory process. I recognise that this emphasis on balance sheet management - which is especially important where a country is seeking actively to manage its exchange rate - may raise the cost of short-term capital inflows; but that seems to me to be a price worth paying for greater protection against sudden capital outflows if confidence declines. Finally borrowing countries are being increasingly encouraged to develop, in the current less febrile environment, an ongoing dialogue with their major external creditors in the expectation that this would help to identify emerging concerns and possible responses at an earlier stage and to promote a more constructive reaction on the part of those creditors when storms begin to gather.

Now, all of these steps are steps which countries themselves can take to reduce the risks of domestic or external macro-economic shocks leading to financial instability, which in turn would be likely to amplify the effects of the initial shock. But with the best will in the world such shocks will no doubt continue to occur. And alongside all this work on what countries can do to help protect themselves, a major review of the terms and conditions of the IMF facilities is taking place, designed to increase the effectiveness of the financial help that the IMF can give to its member countries when they do run into difficulties. This is not an easy issue on which, I know, people hold strong views. We have to try to strike a sensible balance between excessively onerous and excessively liberal conditions attaching to IMF support. On the one hand, if IMF conditions - whether preconditions attaching to quasi-automatic support in the event of sudden capital outflows or adjustment conditions attaching to the Fund's more traditional facilities - if in either case the conditions were too demanding, countries may be deterred from seeking the Fund's help. That in turn could result in unnecessary economic and financial instability. If, on the other hand, IMF assistance were too readily forthcoming, both the member countries, and their creditors, might be encouraged to take excessive risks in the belief that the IMF would in the end bail them out. This is a particular form of the familiar problem of moral hazard. It, too, could result in unnecessary economic and financial instability.

What does seem clear is that, given the scale of private international capital flows today, the IMF's resources are certain to be limited in relation to the problems that could emerge. At some point therefore - depending on just where the balance is struck - the onus for resolving the situation has to fall back on the borrowing country and on its creditors, who cannot avoid taking ultimate responsibility for their own lending decisions.

So there is a link between the review of the IMF's facilities and what has come to be called - in the jargon - PSI, or private sector involvement in crisis resolution. And that link remains to be clarified. Just how these issues are resolved will have an important bearing upon global economic and financial stability, and in turn, upon the safety of our national banking systems.

Somewhat similar considerations apply in the narrower national context. Where, for whatever reason - which may be a result of macro-economic mismanagement by the authorities themselves or a result of mismanagement by banks or other financial institutions - there is a threat to the stability of a sizeable part of the financial system as a whole, it is the national authorities ultimately that have to deal with it.

They can seek to reduce the risks of systemic problems originating in the financial sector in particular in a number of ways.

Firstly, there is regulation or supervision of individual financial intermediaries which may, as here in Sri Lanka be undertaken by the central bank itself or by a separate financial supervisory agency as now in the UK. Financial supervision - including banking supervision - is a powerful instrument for preventing systemic financial disturbance, even when - as in the UK - the primary objective is to provide a degree of protection to the investors or depositors in individual financial intermediaries rather than to protect the system as a whole. But it necessarily has its limitations. The job of the supervisor in this context is essentially to set appropriate minimum standards for the authorisation and prudential conduct of financial institutions and to satisfy himself (or herself!) as far as possible that these standards are being observed. It is not the job of the supervisor actually to micro-manage the institution or the particular risks that it takes. That has to be the job of the management of the institution - indeed the taking and management of financial risk is the essence of their contribution to society; it's what they are paid for! Nor is it the job of the supervisor to prevent each and every bank failure. Indeed, if the supervisor were to attempt to do so, it would inevitably involve such rigorous prudential standards and enforcement that it would effectively stifle innovation and competition, at the cost of reducing the efficiency of the financial system in meeting the needs of the wider economy, but ultimately also of weakening its structure - reducing rather than increasing the safety of the system. So effective supervision is a vitally important part of the answer to improving the safety of the banking system but it is not a complete answer.

Secondly, national authorities can introduce deposit protection arrangements which can reduce the risks of the panic withdrawal of deposits or some other forms of investments - though here too a balance needs to be struck. Overly generous deposit protection carries the danger that it will damage market discipline, by making the depositor indifferent to where he places his deposit, encouraging him simply to look for the marginally higher return.

Thirdly, as I noted earlier, national authorities can do a good deal to strengthen the legal and accounting as well as the corporate governance infrastructure as it applies to the financial system. They can insist upon higher standards of financial reporting and transparency, facilitating better risk assessment of the counterparties and borrowers. And, on the more technical level, they can also ensure that the risks arising from the payments system infrastructure - especially the wholesale payments system - are minimised, reducing the danger that a failure of one institution will set off a chain reaction among other financial institutions that are its direct creditors.

The importance of strengthening our defences in all these various ways against systemic financial disturbances can hardly be over-emphasised. Over the past 15 years something like 150 of the 180 or so member countries of the IMF have experienced significant banking sector distress, in many cases amounting to full-blown crises. Some Bank of England estimates of the costs of financial instability suggest that banking crises have over the past 25 years caused a cumulative loss of output of as much as 15-20% of GDP in the countries concerned.

But finance is, as I say, inherently a risk business. And however much effort we put in to accident prevention - however vigilant we are - we have to recognise that accidents will occur. So we have to be prepared to limit the damage that they may cause. While it may be possible for the authorities in many instances to bring about stabilisation by catalysing action within the private sector - and the way in which the Federal Reserve handled the problems in Long Term Capital Management a couple of years ago is an outstanding example of that - the monetary authorities' ultimate instrument is their capacity, typically exercised by the central bank, to intervene directly - within limits agreed by government since public money is involved - themselves.

As in the case of IMF lending to member countries in difficulties, this "safety net" or Lender of Last Resort (LOLR) capacity needs to be used with great discretion if it is not to give rise to a similar kind of moral hazard - encouraging banks and their creditors to take excessive risks. It is only to be used where there is a genuine risk of systemic financial disturbance - where other banks are liable to be affected by contagion either as a result of their direct exposure to a failing institution or because they are likely to be seen themselves to be exposed to the same sort of pressures that affected the failing

institution, and therefore likely to be similarly vulnerable and subject to loss of confidence. It is only in those circumstances - which I agree are difficult to recognise with total confidence - that official intervention can be justified. The safety net is not there to protect every individual institution that gets into trouble as a result of its own failings.

Even where it is judged that there is a systemic threat - and a public interest in containing it - a judgement that will properly need to be openly justified at the appropriate time - last resort assistance - like IMF assistance to its member countries - has to come with conditions. The purpose of last resort assistance is not to protect either the shareholders or the management of an illiquid, even less an insolvent institution, and the appropriate outcome may well be an orderly run-down or sale of the business. That may sound severe - even threatening to commercial bankers. But it is necessary both to ensure that moral hazard does not undermine the safety and soundness of the banking system and to maintain its competitive efficiency.

Pulling all this together the “authorities” - governments, financial supervisors and regulators, and central banks - have a vital role in creating and sustaining a safer, sounder, banking system. But in the end it depends critically on you - the professional, commercial, bankers. Yours is a tough job at the best of times. It is especially challenging in today’s environment of rapid financial change as a result in particular of the inter-action between deregulation and increasing competition, globalisation and the revolution in information technology, which are constantly bringing new dimensions to your unenviable task of risk management. Your own survival and prosperity - and that of the institutions that you manage - depend ultimately upon your abilities as risk managers. But to the extent that each of you individually succeeds in your own business, you also make a vital contribution to the safety and soundness of the banking system as a whole. As a central banker, I can only wish you well!