Vahur Kraft: Safeguarding financial stability – key issues for the central bank

Speech by Mr Vahur Kraft, Governor of the Bank of Estonia, at the conference on the Challenges for the Unified Financial Supervision in the New Millennium, Tallinn, Estonia, 2 July 2001.

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Good afternoon, ladies and gentlemen.

After the most interesting presentation by Minister Kallas, it is my pleasure to address this distinguished audience on more general issues. Departing slightly from the pre-announced agenda, I will discuss the key challenges to maintain financial stability from the central bank's point of view.

I. Why is the central bank interested in financial stability?

The question "why is financial stability so important for the central bank" does not need to be discussed here in detail. Monetary transmission can not be efficient if weak financial system distorts interest rate signals by increasing margins or if the financial markets have ceased to function as some participants do not trust other players. The causality can run also in other direction. Over the past decade, we have once and again witnessed how weak financial systems have directly caused the currency crisis that resulted in capital flight, devaluation and deep recessions. The latter is particularly relevant for fixed exchange rate systems. And finally, central banks are interested in financial stability because often the central banks would have to take the leading role in crisis resolution, by providing emergency assistance and working out restructuring plans.

These concerns are very familiar to Bank of Estonia. Fixed rate of Estonian kroon and the currency board to support the peg necessitates in strong financial system for several reasons. In the open economy, if the exchange rate is fixed, the interest rates should be let to fluctuate, from time to time within wide margins, to meet the market supply and demand for Estonian assets. That monetary transmission channel from the rest of the world – in our case from the ECB in Frankfurt – to Estonian economy is of vital importance to provide early signals to address emerging imbalances. Financial system is, thus, both the messenger and the first line of defense, as the banks have to withstand volatile interest rates in case of negative expectations and resulting market uncertainty. Lack of lender of last resort even more underlines the essential role the financial stability plays to avoid domestic currency crisis.

As Minister Kallas vividly explained, we have gone through lot of experiences over the past decade. At the outset of East-Asian crisis, Estonian currency system survived the speculative attack that we at these times considered a pure "Asian contagion". The 1-month TALIBOR rates were pushed up from 6 to 15 percentage points in less than 2 weeks. Of course, it became clear afterwards that at least part of the reasons for the attack were entirely home grown. Nevertheless, it showed us very convincingly, – in real life, so to say –, the importance of capitalized and liquid financial system that was able to adjust its risk management accordingly. A year after, as the Russian ruble collapsed, we had to deal with both international and domestic loss of confidence in the financial system during the economic downturn. Again, the interest rates more than doubled (from 8-18%) in a few weeks due to the temporary loss of confidence in the currency. These two episodes provided clear examples of the importance of financial stability for the monetary and, ultimately, economic conditions in case of a fixed rate. But these experiences also provided policy insights that are useful not only under the present circumstances but also for the financial policy making in a common currency area.

II. What are the main challenges for the central bank?

Central bank's direct responsibilities to maintain the financial stability, apart from direct supervisory functions, can be divided into three large areas.

Firstly, central banks are responsible for analysis of financial system developments and to determine the early signs of possible financial difficulties. Central banks are well positioned for that task because of the close relations with market participants and because of the analytical skills that provide natural ground for analyzing the so-called macroprudential indicators and perform regular stress testing.

Secondly, central banks are by definition involved in designing and building up financial system safety nets. The so-called "traditional" central banks are directly responsible for short-term emergency liquidity support to prevent the problems of one institution to develop into a systemic crisis. Even if the ability to provide liquidity assistance is limited, like in case of currency board, central banks take – or are even supposed to take – a leading role in crisis resolution.

Thirdly, central banks are often responsible for regulating the banking system. That is also the case in Estonia, even after the reorganisation of the supervisory function has been completed. Bank of Estonia is responsible for banking regulations while the Ministry of Finance will regulate insurance and securities market. From the central bank's point of view, the banking regulatory policy goes somewhat beyond the traditional micro-prudential approach that is basis for Basle capital accords. The equally important question for central banks is to what extent the banking policy depends on the general macroeconomic conditions or to put it simply, should regulatory changes take into account business cycles or should they be guided solely by concerns on micro level.

III. Early warning systems and macroprudential analysis

Let me now touch upon these three broad categories in more detail. Estonian experiences and the regulatory questions lead me directly back to the first main task – efficient monitoring and analysis. For us, the harsh lessons from late nineties have underlined the need to better understand the key vulnerabilities in financial system. This task has become even more pressing now when Estonian banks have become an integral part of major Scandinavian financial groups. While this development has somewhat lessened our concern for immediate liquidity and capital, the performance of the financial system is yet to be tested during an economic downturn. In essence, we do not know how the strategic partners of Estonian banks would react if the GDP growth will slow, loan losses amount and bank profitability starts to decline. We must be vigilant to grasp the changes as soon as possible.

The key to vulnerability analysis is a successful implementation of ideally several analytical tools, including early warning systems and macroprudential analysis. As we know, the early warning systems typically try to estimate the impact of external factors on domestic financial systems, i.e., how vulnerable the banking sector is to decline in exports or to worsening market sentiment. Macroprudential analysis undertakes to broaden that approach to a variety of economic indicators, using the stress testing models. Several organizations are focussing on these developments, including the BIS, ECB and IMF. The topic gains even more prominence for us as the European Commission, acting on the request from the ECOFIN Council, is starting to prepare the so-called Macro Financial Stability Assessments later this year that would evaluate the resilience of the financial systems of prospective new member states.

Several prerequisites are necessary for the development of reliable and robust early warning systems and even more so for the meaningful macroprudential approach. Reliable data and reasonably long time series is a necessity as well as is the profound intertemporal analysis. All these assets are in relatively scarce supply in EU accession countries with ten years of independent banking history. However, we have got a few initial building blocks in place. We have looked at our banking data in the light of the very recent IMF research and were encouraged that our statistics covers the key indicators fairly well. Secondly, we have dedicated significant resources to improve our analytical skills over the last couple of years. And finally, we have had an encouraging experience on stress testing during the FSAP mission last year, although the approach was simple. Against that background, we will give considerable attention already this year to further upgrade of financial system analysis and we are looking forward to cooperate in that respect with our friends in Europe as well as in Washington.

IV. Safety nets: crisis prevention

From here, I would like to proceed to the other major challenge for the central bank – to build up financial safety net. We know that a full-fledged financial safety net consists of two major pillars: crisis prevention and crisis resolution. Efficient analysis is a sine qua non for every effort to prevent financial difficulties. Of course, we have the problem that all models tend to be perfect in forecasting the past while their predictive power is unknown at best. Therefore, our concern is how to build a network of institutions that would minimize the risk of a sudden shock.

I would like to start this part by stressing the importance of the dialogue with market participants. The constructive discussions with bank managers serve two purposes. The commercial bankers know and in their own way understand both the market situation and the prevailing trends in the so-called "real economy". Thus, these regular discussions are most welcome complement to the economic analysis by central bank experts. But the regular contacts provide also a unique channel for moral suasion, for explaining central bank's concerns and in some occasions, possibilities to put pressure on managerial choices. Obviously, these contacts are easy to arrange in a small country like Estonia. We have made use of that opportunity and established dialogue with our financial sector on financial as well as on general economic issues, both on regular as well as on ad hoc basis. What we should do more is to have more in-depth contacts with the main strategic partners of our banks.

The other essential, albeit specific element for crisis prevention is the pre-emptive involvement of the private sector in crisis resolution. I would like to point out two simple but effective principles that we have relied upon. Firstly, the completely free movement of capital, both long and short term, has increased the credibility of our financial policy and, thus, encouraged strategic partners to take much longer term approach to their investments. That has by now resulted in a full integration of our banks into Scandinavian markets. Secondly, Estonia has avoided volatile short-term capital flows due to strong fiscal stance.

While these "soft" policy principles support crisis prevention by providing relatively stable and transparent environment, the resilience of the system depends ultimately on the actions of market participants themselves. The task of the authorities is to provide an adequate regulatory framework and to undertake maximum effort for the supervision of the implementation of these regulations. There is another interesting, albeit still debated issue – to what extent should the supervisors rely on banks' internal risk control models and ratings. Estonian banking supervisors have taken relatively forward-looking approach in that respect by increasingly relying on risk-based approach of supervision. At the same time, and having in mind rapidly developing economy and currency board arrangement, we believe that our banking system should have also robust liquidity buffers as well as sufficient capital to withstand the fluctuation of asset prices. Therefore, we have set relatively high reserve requirement half of what the banks can meet by the holdings of high-rated foreign assets. We will further adjust the system of reserve requirements in the future as monetary policy framework will converge towards the eurosystem principles.

Finally, I would like to stress that as an essential element of the safety net, the Deposit Insurance Fund is functioning well and has proved its usefulness already two years ago. The immediate task for Estonian authorities is to introduce the investor protection scheme for the other parts of the financial system.

V. Safety nets: crisis resolution

In free market economy, no policy and no supervision can prevent the possibility of financial distress in any particular financial institution. What the public policy can do is to minimize the likelihood of systemic crisis. Crisis resolution is the key to avoid systemic disturbance. As we know, the ultimate policy choice for the authorities is to find the balance between the public sector and private sector solution from the one hand and between the pre-determined schedule and ad hoc approach from the other hand.

Estonia's currency board regime sets for Bank of Estonia clear and strict limits that exclude several options available for the authorities in many other countries. By limiting the money supply to net foreign assets of the central bank, the room for emergency liquidity support is very limited. Therefore, in our case, the private sector solution is preferable and particular modalities of crisis resolution will depend very much on the circumstances. At this point, I would like to refer back to previous parts of my speech and underline that this particular approach rests upon a few strong fundamentals. Continuous analysis of financial system developments and early warning indicators, importance of strong owners and sound risk management in banks, high liquidity and capital requirements – these basic principles are a necessity for us.

By combining the principles just mentioned, we can now describe a few hypothetical crisis resolution situations in Estonian financial system. In some cases, the extreme private sector solution – winding-down of the troubled institution – would probably be the preferred approach. The Law on Credit Institutions together with the Bankruptcy Act provides central bank and other authorities with all necessary powers for closing down the business and letting trustees to take care of the practical aspects. The Deposit Insurance Fund will immediately reimburse all depositors within legal limits.

Of course, in other situation, different approach must be taken and a strict adherence to the former rule is not feasible. Nevertheless, the initial response would still be the private solution. One option would be the central bank to take the lead as an honest broker and bring together all private and official parties concerned. Ideally, that would result in design of ad hoc private solution in a form of merger, acquisition or emergency support. The role of central bank would effectively be the application of moral suasion, without committing public funds.

However, one can and should not wholly dismiss the need for direct public intervention should it become necessary. What will be different in our case is that in case of serious trouble, the dividing line between liquidity support and capital injection would be rather blurred or these operations may even take place simultaneously, after writing down capital of the troubled institution. The need for very close coordination between the central bank, the government and supervisors is characteristic feature of this approach.

Finally, there is perhaps no need to say that over the past decade, we have indeed applied all these scenarios on our financial institutions in very real circumstances.

VI. Regulations: pro or counter cyclical?

Finally, let me briefly touch upon the regulatory issues. Bank of Estonia is responsible for regulating the banking system in Estonia. The detailed description of Estonian banking regulations goes far beyond the scope of my speech, but I would just like to say that one advantage of being a transition economy was the possibility to draw the legislation from the scratch. That has facilitated very much the compliance with good practices and de facto full adoption of the EU acquis.

What is a real regulatory challenge for central bank in our case is the question of to what extent regulatory measures should be taken into account in broader financial policy context. Arguments can be made for changing the regulations in accordance with the business cycle, especially as it seems that in modern world financial systems have become more pro-cyclical than before. In that case, early tightening may pre-empt the possibly devastating effects of asset price volatility and loan losses once the economy starts to cool down. That might be even more relevant if credit growth is high in the early stage of the cycle.

This approach has particular appeal for policy makers under the currency board as the active use of monetary measures is excluded and reserve requirements are essentially the only available monetary tool. In these circumstances, tightening prudential measures early on might seem a very reasonable thing to do. It is important to underline that in heavily bank dominated financial system, banking regulations might serve also as an instrument to affect domestic demand more directly than under other circumstances. Indeed, Bank of Estonia increased capital adequacy ratio on more or less cyclical grounds in 1996 and tightened capital requirements further at the onset of Asian contagion, before the peak of the cycle.

Having said that, one should not look over the possible caveats of this "macro-prudential" policy approach. One obvious shortcoming is that as financial markets do mature and financial instruments become more complex, tightening banking regulations will simply intensify financial disintermediation. In that case, major capital flows will be channeled to less regulated areas that will bring about new risks of potentially systemic nature. The second problem is that the determination of the exact stage of business cycle is simply impossible. The longer it takes, the more weight is given to the consideration whether the tightening would not emerge too late and contrary to the best intentions, would contribute to pro-cyclical behavior of banks. To be honest, we have recently thought what approach would be suitable for us to take at present and we have understood that the topic is debated also in several present EU member states.

VII. Conclusions

After I prepared this presentation, I started even more to support the old truth in slightly modified wording – maintaining financial stability is more the art than the science. Maintaining the financial stability is the mission impossible for one institution to carry out in isolation, be it the central bank or any other authority. What is needed is shared data, shared analysis that brings together macro and micro prudential aspects of financial stability, common set of principles to fall back in case of systemic crisis, and perhaps most essentially, there is a need for common mindset.

I would like to highlight one essential aspect of financial stability. The pan-European consolidation of banking industry has resulted in rapid increase of cross-border ownership. The question of co-operation between central banks and supervisors is the key to maintain sound financial systems. That applies both to crisis prevention as well as to crisis resolution. How to pass on early warning signals, how to provide emergency liquidity support, how to restructure or wind up big financial conglomerates – these questions are highly relevant for us as well as for the whole common market.

I believe this a good time to stop and pass the word over to our moderator who will elaborate more thoroughly on the other mission impossible: how to find a right institutional structure for financial sector supervision.

Thank you for your attention.