Malcolm Edey: The financial stability role of central bank

Address by Mr Malcolm Edey, Assistant Governor (Financial System) of the Reserve Bank of Australia, to the Thomson Reuters' Australian Regulatory Summit, Sydney, 1 May 2013.

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I have chosen as my subject today the financial stability role of central banks.

One of the consequences of the recent financial crisis has been a rediscovery, or at least a renewed appreciation, of that role. If we think back to the pre-crisis period, it seems fair to say that most of the public attention given to central banking was focused on the conventional monetary policy function – that is, the regular adjustment of interest rates for inflation control.

Without in any way diminishing the importance of that function, it is certainly the case that the financial stability role of central banks has increased in prominence since the crisis. We can see that in several ways. Central banks played a crucial part in the initial crisis response by providing emergency liquidity support to institutions and markets under strain. In many cases they held direct regulatory responsibilities for dealing with troubled institutions, or else cooperated closely with the agencies exercising those powers. And they have played a key advisory role in helping to shape the post-crisis regulatory environment around the world. During this period, governments in a number of jurisdictions have taken steps to strengthen the financial stability mandates of their central banks and in some cases have given them additional regulatory powers to that end.

One commentator has gone so far as to say that the financial stability role of central banks has been rediscovered with a vengeance [1]. I want to explore today what that might mean in practice.

The first point to make is that the financial stability role of central banks is not new. In his book *The Evolution of Central Banks* [2] Charles Goodhart argues that financial stability was an original core function of central banks, arising from their unique position as lenders of last resort to the banking system.

It is worth focusing briefly on the economic rationale for that role. It derives from the nature of banking itself. Banks are intermediaries that engage in credit evaluation and maturity transformation in order to link borrowers and lenders. In doing so they perform a function that has become vital to the modern economy, but the history of banking shows that, without proper supporting arrangements, the system can be vulnerable to instability. One source of instability that became evident as banking systems developed was their vulnerability to runs and panics. Put simply, even a sound bank could be put at risk if it were forced to liquidate its assets in a panic, and the best defence against that was to give them access to a central source of liquidity [3]. Central banks evolved, or were established by governments, to meet that need.

Historically this role had important synergies with other central banking functions, and with other aspects of what we now call financial stability policy. Under the gold standard, the lender of last resort (and the related liquidity management) functions were closely intertwined

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[1] Buiter (2012), The role of central banks in financial stability: how has it changed? CEPR Discussion Paper Series No. 8780.

[2] Goodhart (1988), The Evolution of Central Banks, MIT Press. For a more recent discussion, see Goodhart (2010), The Changing Role of Central Banks, BIS working paper 326, http:/www.bis.org/publ/work326.pdf

[3] By this I mean a last line of defence. I don't mean to imply that banks should not hold liquid resources of their own in the first instance.

with the price stability objective. The gold standard was seen as a general discipline against inflation or deflation. Central banking actions to preserve the gold standard were therefore seen as both promoting price stability and also promoting the capacity of banks to meet their obligations – in other words, financial stability.

Part of that general role involved managing monetary systems in a way that would reduce the risk of panic and instability in the first place. But it also meant applying Bagehot's famous principle that central banks should lend freely, at a penalty rate and on good collateral, in the event that a crisis occurred. The liquidity management role of central banks also led naturally to their engagement in other areas of financial stability policy, including exercising a degree of oversight of the banks that they were lending to.

Obviously the world now is very different from what it was in Bagehot's day. We no longer have a gold standard, and financial systems are much more complex than they were then. But I began with that background in order to emphasise an important point of historical continuity. Central banks retain a key role as liquidity providers and managers today, and these functions continue to have important synergies with other aspects of financial stability policy.

How then should we think about financial stability policy in the modern environment, and how should we think about the central bank's role in particular? I want to provide some general thoughts on that question while acknowledging that this is not an area for simple answers.

When economists talk about policy frameworks in a given field, they like to think in terms of a taxonomy that has (at least) the following main elements:

- First, the objectives – what is the policy aiming to achieve?
- Second, the instruments – what are the tools available for achieving them?
- Third, the strategy – what are the logical processes linking the instruments to objectives?
- And finally, governance – who are the decision makers, and how are they held accountable?

In the case of the monetary policy function of central banks these questions have been well studied, and there is by now a well-established consensus as to what constitutes a best practice framework, at least in general outline. It could be summarised as follows:

- The objective is inflation control, possibly defined as a numerical target and possibly broadened to incorporate some element of business cycle stabilisation.
- The policy instrument (in conventional circumstances) is the short-term interest rate[4].
- The strategy could be modelled as something like what economists refer to as a 'forward-looking Taylor rule'. This essentially says that the interest rate is adjusted to lean against fluctuations in output and inflation, in order to exert a stabilising influence on both.
- And the governance structure should involve the government setting the objective and an independent central bank controlling the policy instrument, subject to appropriate accountability.

Obviously this summary glosses over a vast amount of detail, but in concept at least the framework is reasonably well studied and well accepted.

For financial stability policy, the position is much more complex.

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[4] I leave aside here the question of 'unconventional' measures when interest rates are at or near zero.

The ***objective*** might be defined as something like *avoid financial instability*, or perhaps slightly more scientifically, *keep the risk of system-wide financial disruption acceptably low*. These things of course can't be readily quantified, at least at the level of the system as a whole. There is no simple measure of system-wide financial risk, and the concept certainly can't be expressed as a numerical target in the way that can be done for the inflation objective. That doesn't mean, however, that the task is hopeless. We are better, I think, at identifying particular sources of risk, like excessive leverage, poor credit standards, or leveraged asset booms, than we are at aggregating them or quantifying their likely systemic impacts. We do know financial instability when we see it, and we have a good idea of the kinds of behaviour that can contribute to it. The objective, then, is to manage these risks to an acceptable level.

The second element is the set of policy ***instruments***. Here again, the position is much more complicated than it is for the inflation targeting framework. The potential instruments of financial stability policy are many and varied. One component I have already mentioned: the central bank's role in liquidity management. Other instruments include the range of regulatory requirements that influence risk taking in the financial sector, like capital and liquidity standards. These are what might be termed 'structural' prudential instruments aimed at promoting a generally robust financial system. In addition there is a growing interest in the potential use of 'macro-prudential' tools in a time-varying and targeted way to respond to risks as they evolve. Examples that feature in international debate include things like maximum loan-to-valuation ratios that might be targeted at cycles in property lending, or the counter-cyclical capital buffer incorporated in the Basel III standards, aimed at general credit cycles. In addition to all this must be added the capacity of prudential supervisors to influence and respond to banks' risk taking without the use of prescriptive rules. In Australia's case I think we have been well served by APRA taking a pro-active approach on this front to ensure that risks in the banking sector have been well understood and well managed. I think of this as a policy 'instrument' in my general schematic outline, but it is not one that can be easily quantified or formalised.

The third element of my outline is the ***strategy***. How are the instruments deployed to meet the objective?

It should be clear from what I have said so far that the policy strategy in this area can never be as tightly defined or modelled as it might be in the monetary policy sphere [5]. No one would seriously think of trying to use the equivalent of a Taylor rule to summarise financial stability policy. But clearly the policy approach needs to include at least the following components:

- Appropriate management of system liquidity, including a framework for providing emergency liquidity in a crisis.
- Capital regulation to ensure well capitalised banks.
- Supervision to promote sound loan lending standards and guard against imprudent risk taking in the banking sector.
- Sound risk controls for other systemically important institutions, including providers of critical financial infrastructure.
- Robust crisis resolution frameworks.
- Ongoing monitoring and analysis of systemic risks, including in asset and credit markets; and
- Appropriate coordination among the key policy makers.

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[5] Arguably most fields of public policy are unlike monetary policy in this sense.

Central banks and supervisors have been working to strengthen all of these elements since the crisis. Internationally, there are clear benefits to collective effort in a number of these areas. In the area of bank regulation, for example, countries have a mutual interest in the development of common minimum standards to promote resilience for the global system as a whole. The Basel III package of capital and liquidity standards represents a major outcome of that cooperative effort [6].

That brief outline might be thought of as capturing some important commonalities in the way various countries are approaching financial stability policy in the wake of the crisis. But there are also some significant differences in national approaches, especially in an organisational sense.

That brings me to the fourth element of my outline, which is that of ***governance*** or, put simply: who controls the instruments?

I have already made the point that one part of the instrument set – the management of financial system liquidity, or the last resort lending function – is inherently a function of the central bank. Internationally, one of the areas of recent debate has been on the extent to which this and other central banking functions should be combined with prudential regulation, or whether they are best kept separate. And, if they are not combined, how can they best be coordinated, given the synergies between them?

In current international practice there are a variety of different approaches to this question. Australia of course is a jurisdiction that has an integrated prudential regulator separate from the central bank. Other examples of that structure are Canada and Japan. The United States and Europe have complex arrangements that fall somewhere in the middle. The UK has just completed a transfer of the prudential regulation function back into the central bank after separating them in the late 1990s. Indonesia is in the process of shifting in the opposite direction. So clearly there are a variety of different organisational models. In many cases, including Australia, central banks have a general mandate to use their powers to promote financial stability, even if they are not the primary bank supervisor.

A key consideration in all of this is the obvious synergy between central banking activities, prudential regulation, and crisis management and resolution responsibilities. The position of central banks in financial markets is likely to give them early visibility of many types of financial stress, and their position as the system liquidity provider gives them an essential role in crisis management. For these and other reasons there is a clear need for ongoing coordination of these various roles. But coordination is not necessarily best achieved by organisational unity. Arguments can be advanced for a range of different institutional structures, and it is perhaps not surprising that countries have come to differing conclusions, depending in part on their own histories and their experiences during the crisis.

With that general background, I want to conclude with some observations about how we organise these things in Australia [7]. In particular, to come back to my original focal point, I want to ask what is the role of the Reserve Bank in Australia's financial stability arrangements.

It is sometimes said in answering that question that the Bank is the macro-prudential authority in Australia and APRA is the micro-prudential authority. The implication is that the Bank looks at stability from the point of view of the system while APRA looks only at the individual institutions. I think that is at best an oversimplification and is an unhelpful way to

6 Other examples include common mortgage underwriting principles, and the development of regulatory standards and resolution regimes for critical financial market infrastructure.

7 For a comprehensive discussion of financial stability arrangements in Australia, see the joint RBA and APRA document Macroprudential Analysis and Policy in the Australian Financial Stability Framework, http://www.apra.gov.au/AboutAPRA/Publications/Documents/2012–09-map-aus-fsf.pdf

look at the two institutional roles. It presupposes that it is possible to focus on the system as a whole without taking an interest in the individual components; or, conversely, that an agency can sensibly look at the parts without being interested in how they interact with the whole [8].

The difference between the two roles, I suggest, is best understood in terms of their powers and responsibilities rather than their objectives. APRA has powers and responsibilities that relate mainly to individual institutions, but its legislative mandate includes stability of the system, and it can adjust its prudential settings to address system-wide concerns. The Bank has a broad financial stability mandate, existing in conjunction with other macroeconomic objectives and attached to a very different set of powers.

In a legal sense the Bank is authorised to provide financial services to the government and to the financial system, and has significant powers to engage in financial activities in the public interest. As I have said, those powers enable the Bank to act as lender of last resort and liquidity manager for the financial system in addition to its better-known role in conducting monetary policy.

When bank supervisory powers were shifted from the Reserve Bank to APRA under the 1998 Wallis reforms, the Bank's general mandate to use its powers to promote financial stability was reaffirmed. This was more recently emphasised by the incorporation of reference to the financial stability mandate into the Statement on the Conduct of Monetary Policy in 2010. The Wallis reforms and subsequent legislative changes also gave the Bank significant regulatory powers in relation to the resilience of the payments system and of financial market infrastructure.

In summary, then, the Reserve Bank and APRA have different powers but overlapping and complementary objectives in relation to financial stability.

It goes without saying that the two institutions have a strong appreciation of the need to work closely together and to coordinate with the other key agencies, especially ASIC and the Australian Treasury. There are a number of mechanisms, both formal and informal, for achieving this. At the peak level the four agencies form the Council of Financial Regulators, chaired by the Reserve Bank Governor. Numerous other coordinating arrangements exist at the staff level. Although the Council is a body without formal powers, it has played an important role in a number of different ways, including information sharing, helping to develop the overall post-crisis response and in making coordinated recommendations to the government. Internationally I find that there is a lot of interest in the Australian coordination arrangements, and it is interesting to observe that a number of other jurisdictions have moved to develop financial stability council structures of their own in the wake of the crisis.

To recap briefly, I have tried to outline what I see as the main elements of financial stability policy, to explain why the central bank has a key part in it, arising from its role as system liquidity manager, and to highlight the need for coordination between the central bank and other agencies, especially the prudential regulator.

All of that falls well short of a general theory of financial stability, unavoidably so because I don't think such a theory is achievable. Nonetheless, I think the arrangements that I've just described have generally served Australia well. During the recent period of global financial stress, our banking system and our crisis management arrangements have proved more resilient than most.

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[8] For more details on this point, see Edey, Macroprudential Supervision and the Role of Central Banks, and Ellis, Macroprudential Supervision: A Suite of Tools or a State of Mind?

In the end, of course, what counts is not the way financial stability policies are allocated to particular agencies but the quality of their implementation. And that of course remains the focus for the Reserve Bank, as well as for the wider body of financial regulators in Australia and abroad.