Financial stability objectives and arrangements – what's new?

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Introduction

The global financial crisis has raised a number of questions concerning the role of central banks in the area of financial stability. Any changes in their role may affect the suitability of their governance arrangements. One of the immediate challenges is the difficulty of specifying a mandate for financial stability. Another is ensuring that any financial stability mandate is consistent with the other mandate(s) of the central bank. Yet another is the need to design structures to operationalise the mandate. This paper briefly surveys the issues relating to the setting of financial stability mandates in law and examines recent changes to financial stability arrangements involving the central bank.

1. Financial stability objectives – what is the issue?

The report of a study group headed by Stefan Ingves, Governor of Sveriges Riksbank, noted the heightened need for accountability in financial stability actions; the special role that clear objectives play in accountability; and the difficulties in creating such objectives.[1]

Three problems beset objective-setting for financial stability: defining what is meant by the term; quantifying the objective; and dealing with the large number of dimensions, many involving trade-offs. Together, these problems make the pursuit financial stability objectives much more difficult to achieve than those of price stability. To use the inflation targeting example, price stability objectives commonly indicate a numerical reference level or range for a specific index (representing the relevant set of prices), and a time frame that reflects concern about a particular trade-off (ie not to add unnecessary real economic volatility). While the contrast with objectives for price stability may be exaggerated, "financial stability" alone as an objective leaves wide open the important questions of how much stability is desired, in what elements of financial system behaviour it is desired, and at what expense with respect to other policy concerns?

1.1 Defining financial stability

Defining "financial stability" with sufficient clarity to guide actions and create a structure for accountability is difficult. The Ingves Report noted five different types

[1] Bank for International Settlements (2011): *Central bank governance and financial stability*, a report from a Study Group of the Central Bank Governance Group.

of definition for financial stability (including, for example, the smooth functioning and robustness of the financial system). These various definitions emphasise rather different aspects of economic functioning that might be subject to market failures, or different externalities that motivate policy intervention. Financial stability is remarkably multidimensional.

1.2 Quantifying financial stability

A few characteristics highlighted in the different definitions are potentially quantifiable (eg what proportion of certain financial services have stopped functioning), but most are not. The quantification problem is perhaps overstated in comparisons with price stability objectives. The concept of general economic welfare is difficult to quantify, yet the equivalent of such a concept can be found in many stated policy objectives for price stability. Also, very few legally specified price stability objectives feature quantification (or, for that matter, define what is meant by price stability). Almost all inflation targeting arrangements are documented in lower level, non-statutory forms (eg within a central bank's strategy statement). And even if some elements were quantifiable, multiple trade-offs would nevertheless be faced by policy makers in the absence of a straightforward method for (eg) setting off, say, x units of services not functioning against y units of mitigated asset price cycles. Still, some quantification could be useful, wherever possible.

1.3 Multidimensionality and trade-offs

The core problem examined in this paper is the multidimensionality of financial stability policy, and especially the potential for conflict between the different dimensions. To make the multidimensionality question and the potential for conflict more tangible, consider the nine potential components of a financial stability objective as listed in Box 1.

Box 1

Considerations relevant to the regulation of financial activity

1. Ensure support for economic growth from efficient and innovative financial intermediation.
2. Allow some asset price fluctuations that send useful signals about evolving resource values, but resist others.
3. Allow some variations in credit conditions and non-price signals (eg degrees of credit rationing) that correlate well with fundamental changes in intertemporal values, but resist others.
4. Provide support for economic activity by ensuring continued availability of critical services.
5. Provide certainty of property rights for investors in financial service provision, as for others.
6. Provide creditor protection, especially for naïve creditors.
7. Protect the taxpayer from unpriced or subsidised insurance of private profits.
8. Compromise price stability objectives only if the long-run costs are clearly dominant.
9. Ensure scope for reaping the rewards of internationally competitive financial services.

Note: This list is intended to be illustrative rather than exhaustive.

The potential for internal conflicts within this list is immediately apparent. Arising partly as a result of problems inherent in the use of regulatory instruments, such conflicts may include the following: regulatory constraints designed to achieve 2 and 3 may conflict with 1 and 9. Failure of regulation to fully achieve 2 and 3 may also impact on 8. The pursuit of 6 may harm the attainment of 7, as may the attempt to meet objective 4 when things go wrong. One could easily find other potential instances. Of course, these potential conflicts are, in many cases, only relevant in the short term. They may be mutually consistent in the long term. But that is also true with the stability of prices and the real economy – conflicts appear most acutely in the short term, yet they are highly relevant to practical policy implementation.

Practical guidance on how to resolve such conflicts in legislation is next to non-existent. Most financial stability objectives tend to be set at a high level of generality. The most comprehensive example of an attempt to spell out the range of considerations relevant to a multidimensional objective is found in the UK Banking Act (2009) – albeit for a single component of financial stability policy, namely bank resolution. Section 4 of this Act sets out five objectives that are to be considered when special resolution regime powers are used:

1. to protect and enhance the stability of the financial systems of the United Kingdom, with particular reference to the continuity of banking services;
2. to protect and enhance public confidence in the stability of the banking systems of the United Kingdom;
3. to protect depositors;
4. to protect public funds; and
5. to avoid interfering with property rights in contravention of EU treaties.

The Act further says that the order in which the objectives are listed is not significant; that they are to be balanced as appropriate in each case; and that, after consultation with other authorities, the Treasury shall issue a policy strategy (a "code of practice") that may provide guidance on how the special resolution objectives are to be understood and achieved, and the choice between different options. In other words, the legislature has established a multidimensional objective, recognised that the various dimensions may conflict, and set down a process for further elaboration on how to understand and apply the objectives in practice.

1.4 An overview of financial stability objectives in central bank laws

As noted, most financial stability objectives in law, being high level, are limited in detail. Graph 1 (left-hand panel) categorises the existing financial stability objectives applying explicitly to central banks found in the laws of 114 countries (see also Appendix Table 1 for further details). Coverage does not reflect financial stability objectives that may be implicit in functions, tasks, traditions, and membership of inter-agency councils (IACs) that have such objectives (unless the IAC's objectives explicitly apply to or override the central bank's own). The focus on explicit statements makes the researcher's task easier, but it also reflects the fact that implicit objectives are necessarily fuzzier, being formed in the eye of the beholder. They may well differ between people and over time.

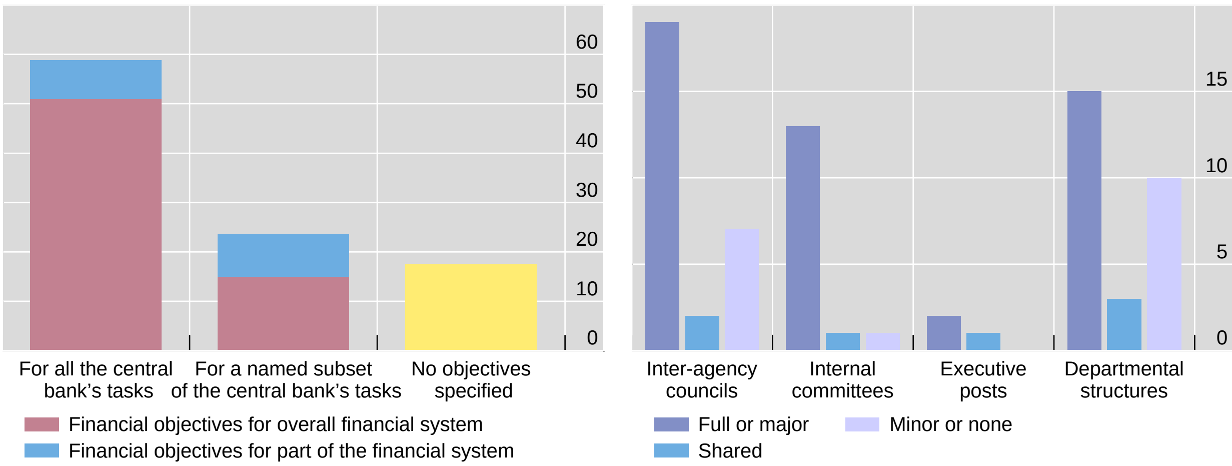
The basic messages obtained from the categorisation presented in Graph 1 (left-hand panel) are:

- A high proportion (82%) of central banks have some form of explicit financial stability objective.

Financial stability objectives in central bank laws; number of organisational changes related to financial stability observed at central banks — Graph 1

Percentage of central bank laws that mention "stability" or a close synonym[1]

Absolute number of changes since 2005, across surveyed institutions by type and involvement in banking supervision[2]



[1] Based on a review of 114 central bank laws and statutes. [2] Based on a survey of 40 central banks and monetary authorities.

Source: BIS.

- Of these:
  - for four fifths, the objective pertains to the entire financial system; for the others the objective formally pertains only to a part of the system (typically the banking system or the payments system);
  - for more than two thirds, the objective appears to be generic, applying to all of the central bank's functions; for the others it explicitly relates to a particular task or function (such as bank licencing, lender of last resort actions);
  - for just over half, the objective is explicitly secondary to another (usually price stability) objective (shown as bracketed countries in Appendix Table 1); and
  - for also just over half, the objective is expressed in qualified (rather than "absolute") language, such that the central bank is required to contribute to, or work towards, or use best endeavours in the pursuit of (rather than to ensure, guarantee, maintain, safeguard) financial stability.
- In almost one fifth of the central banks with a financial stability objective, the objective appears to go further than many would see as realistically achievable. The objective appears to cover all functions and activities, be equal-ranking with other objectives, to pertain to the entire financial system, and be absolute in form (in principle, requiring the unqualified assurance or guaranteeing of financial stability).

1.5 Some recent objective specifications in more detail

Looking at legislative changes that have occurred since 2009, there are at least 21 cases where the central bank itself has seen a revision to its financial stability mandate by way of a change in the statement(s) of objective(s). However, within this group, only two laws elaborate on the meaning of "financial stability".

The Central Bank of Malaysia's law is explicit in that the continuity of services and public confidence are stated to be prime elements of financial stability. Thus, in the chapter dealing with financial stability powers, a risk to financial stability is defined as something that "disrupts, or is likely to disrupt, the financial intermediation process … or affects, or is likely to affect, public confidence in the financial system or the stability of the financial system" (Section 29).

The new Financial Services Act in the United Kingdom also elaborates on the meaning of financial stability, in the course of establishing objectives for the relevant actors. This legislation is of particular interest for outside observers, for two reasons. First, objectives are being written simultaneously for several agencies, covering both macro- and microprudential policies as well as those related to market conduct. And second, the above-mentioned example from the 2009 Banking Act – an unranked multidimensional objective with a defined process for strategic interpretation – is, in principle, a viable model for the setting of new financial stability objectives. For each of the agencies, the new legislation will enact multidimensional objectives that explicitly intersect. There is an elaboration of the features of financial stability that are of most interest to the legislature: namely financial system resilience such that continuity of critical services is assured, and credit bubbles are avoided. The new macroprudential agency (the Financial Policy Committee) will also have the explicit secondary objective of facilitating growth. These objectives will (not surprisingly) be more complex to implement than those of the Banking Act, but there is some ranking of priorities.

1.6 Interactions between price and financial stability objectives

One of the main potential trade-offs of concern has to do with the price stability objective of monetary policy. Here the Malaysian case is again worth particular mention. Since 2009, the Central Bank of Malaysia has had a financial stability objective that ranks equally with price stability ("The principal object of the Bank shall be to promote monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy" (Section 5(1)), and amongst the Bank's "primary functions" is "to promote a sound, progressive and inclusive financial system" (Section 5(2)). The Law of the Central Bank of Montenegro (Article 4) is also noteworthy in that it makes financial stability the prime objective.

In all the other cases of legislative change, financial stability is subordinated to price stability, or the law is silent on the issue. As an example of the former case, the Reserve Bank of New Zealand Act 1989 states in its Purpose clauses ((Section 1A) that the central bank is responsible for "(a) formulating and implementing monetary policy designed to promote stability in the general level of prices … and (b) promoting the maintenance of a sound and efficient financial system …", yet later sections say "The primary function of the Bank is … stability in the general level of prices" and "In formulating and implementing monetary policy the Bank shall … have regard to the efficiency and soundness of the financial system" (Sections 8 and 10 respectively).

It worth noting that, in some countries, new legislation has led to far-reaching changes in financial stability arrangements without providing the central bank with a financial stability objective. For example, the Dodd-Frank Act did not create an explicit financial stability objective for the Federal Reserve. Financial stability is mentioned in Dodd-Frank's preamble as a purpose of the legislation, but the remainder of the legislation focuses on aims to be achieved (eg increasing accountability and transparency; reducing the risk of too big to fail; ending bailouts; protecting consumers from abusive practices) without linking those aims specifically to the various agencies mentioned in the law.

2. Organisational changes relating to the financial stability function

2.1 A typology of institutional arrangements

Over the past few years, numerous countries have made substantial reforms to their financial stability arrangements. The report prepared under Governor Ingves identified four main possible configurations for the assignment of policy functions among responsible agencies, each having advantages and disadvantages.

2.1.1 Macroprudential policy as a shared responsibility

A first approach is to form a macroprudential or systemic risk council to coordinate the work of the various agencies responsible for financial stability. A crucial issue is whether such a council is simply a vehicle for joint analysis and peer pressure or a decision-making body in its own right. Do the agencies represented on the council retain autonomy over their own spheres of interest, or can the council direct policy actions by member (and even non-member) agencies?

The European Systemic Risk Board (ESRB), which became operational in early 2011, has no formal directive powers but is allowed to issue recommendations or warnings to a wide range of European supervisory agencies and to member states directly where systemic risks are deemed to be significant. Publication of recommendations or warnings will be subject to majority decision by the ESRB's governing body. In the United States, the Financial Stability Oversight Council (FSOC), established in 2010, has some formal decision-making powers and can designate institutions and financial services providers that require heightened prudential standards, and make binding recommendations to primary supervisors with respect to heightened regulatory requirements.

2.1.2 Macroprudential policy as a responsibility of the central bank; separate microprudential regulators

A second approach, which exists for example in various incarnations in Japan and Sweden, is to delegate responsibility for macroprudential policy primarily to the central bank while leaving responsibility for microprudential policy to other agencies. The relationship of the central bank with microprudential authorities will depend on what the central bank's macroprudential function involves. If this requires the central bank only to "lean against the wind" in executing monetary policy, the need for interaction with microprudential authorities will be limited. But greater interaction will be needed if the central bank's macroprudential role involves regulatory measures, such as determining a macroprudential overlay on capital or liquidity requirements. In such cases, the central bank could become the regulator and the microprudential agencies would become the policy implementers. This arrangement could trigger inter-agency rivalry and complicate the independence of the microprudential regulators with respect to their spheres of responsibility. But it is by no means rare for microprudential regulators to implement policy settings determined by others.

2.1.3 Central bank as macro- and microprudential policy agency; separate financial product safety regulator

A third variant, which was recently introduced in the United Kingdom, is to integrate macro- and microprudential policy within the central bank while maintaining a separate financial product safety regulator. In principle, this provides improved access to information and expertise. However, potential advantage and actual gain are not necessarily the same. Silos of responsibility within the organisation could still fragment information and analysis. Differing intellectual frameworks implied by the various functions could inhibit communication. Crossing divisional boundaries is not easy and may indeed be inappropriate in some instances (eg with respect to commercial secrets, yet-to-be-announced policy actions etc). Whether these gaps can be bridged, and silos avoided, by bringing these functions together under forceful management is an open question.

In the new arrangements implemented in United Kingdom, the various policy functions will be clearly separated, with a Prudential Regulation Authority (PRA), a Financial Policy Committee (FPC) and a Monetary Policy Committee (MPC).[2] Coordination of the analysis are ensured in part by cross-membership of the top officials represented in the committees and authorities. But coordination of decision-making is strictly limited to specified actions, which do not include anything that alters the role and independence of the MPC.

Several elements of the UK approach have already been adopted in France. Reforms introduced in 2010 consolidate several regulators into an autonomous super-regulator, the Prudential Supervisory Authority (PSA), which is located within the Bank of France, chaired by the Governor and explicitly mandated for financial stability. Measures were also taken to improve consumer protection under the Financial Markets Authority, which will remain independent but will work in close cooperation with the PSA.

The choice of internal decision-making structures within the central bank will have important implications when it comes to dealing with potential conflicts and trade-offs. Where the same committee makes decisions on both monetary and financial stability policy, coordination costs will be reduced, allowing in principle for maximum synergies and more rapid reactions. But for accountability, the actions and analysis of a single committee would need substantial disclosure in order to clearly articulate the nature of the trade-offs and the reasons for specific choices in any given situation. Decision processes that are delegated to separate decision-making boards – each with their own disclosure requirements – presumably make

2 The legislation will also devolve responsibility for the regulation of business practices across the entire spectrum of financial services to a new specialist regulator, the Financial Conduct Authority (FCA).

trade-offs more obvious, since each decision-making group will relatively quickly identify the other as a barrier to success.

2.1.4 Separate macroprudential agency with distributed implementation

The last approach involves the creation of a specialist agency for the macroprudential function. A separate agency would probably have advantages of a clear dedication to macroprudential issues and speed of decision-making. However, implementation could be a problem, since the policy instruments used to implement macroprudential policy are usually assigned to other policy objectives or are under the control of other agencies. It would also raise issues with respect to the autonomy of the other agencies, as is the case with arrangements involving macroprudential councils. Interestingly, the United States was the only country where such a reform proposal was considered. But it did not materialise in the final legislation.

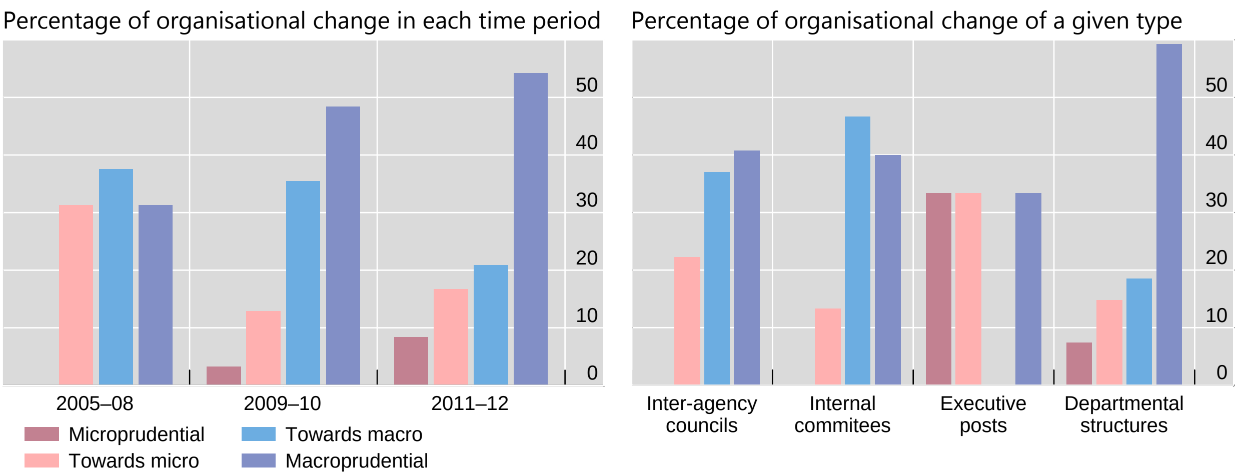
2.2 The choices being made on institutional arrangements

Based on a 2012 survey of 40 countries, institutional and organisational changes related to financial stability were commonplace over seven years up to 2012. Only three central banks made no change at all during the period. New or reformed inter-agency councils (IACs) and new or changed internal structures were the most frequent. The creation or substantial modification of top-level positions related to financial stability were the least frequent.

Graph 1 (right-hand panel) shows the survey data, subdivided by the extent to which the relevant central banks have supervisory responsibility. Relatively speaking, those with full or major supervisory responsibility were more likely to be involved with a new IAC than to have changed their own departmental structure, whereas the opposite was true for those with little or no supervisory responsibility. Organisational changes were often made in tandem. The most frequent pairing –

The micro- or macroprudential orientation of changes, by type of change and over time

Graph 2



Based on a survey of 40 central banks and monetary authorities.

Source: BIS.

observed in about a third of central banks – was a new IAC and a parallel (or closely related) change in departmental structure. Other pairings involved a new IAC and a new internal committee, or a new internal committee coupled with a change in departmental structure.

From this data we can also observe the choices made regarding the four institutional designs identified in the report prepared under Governor Ingves. As one would expect, most of these institutional and organisational changes involved bringing macroprudential considerations to the fore. That tended to be more the case in the most recent period than in the earlier one (Graph 2 left-hand panel). And it was more the case for new departmental structures than for the other types of change (Graph 2 right-hand panel).

2.3 A more detailed look at new financial stability arrangements

2.3.1 New IACs

IACs focused on financial stability are not completely new.[3] But more than two thirds of central banks in our sample reported being involved in at least one new (or substantially changed) IAC since 2005. Most IACs were reportedly established to share information and to conduct a coordinated monitoring of financial conditions. Fewer were described as also being responsible for crisis management.

While central banks are receiving stronger mandates in the area of financial stability, they do not often have the main say in IACs. In only about one tenth of the 37 new IACs is the Governor in the chair (Graph 3, left-hand panel). In about one quarter, the central bank (normally the Governor) shares the chair with others, on either an ongoing or a rotating basis. Otherwise, the chair is typically occupied by a representative from the ministry of finance (often the minister) or from a regulatory agency.

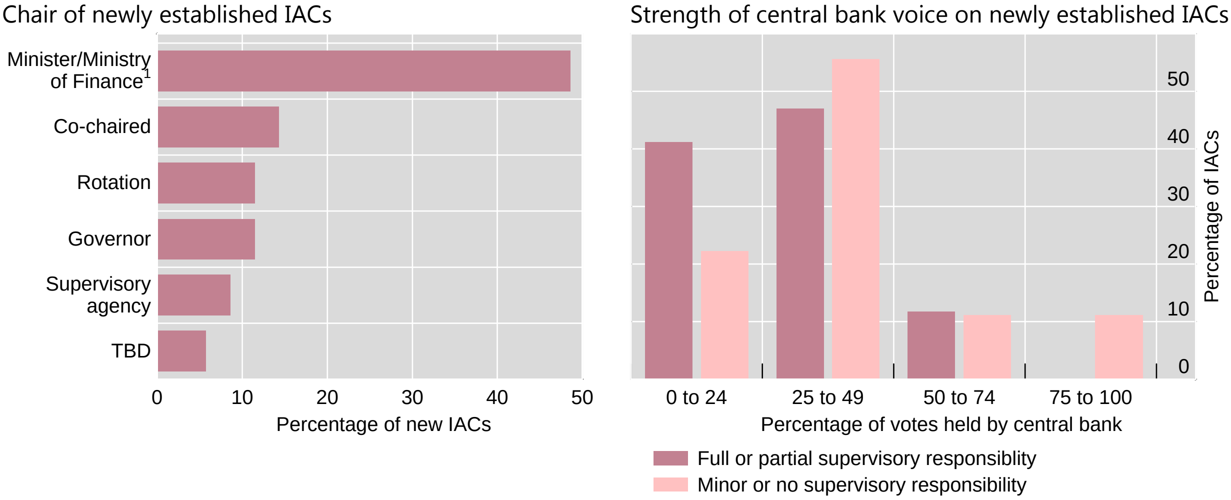
In terms of the strength of the central bank's voice on the newly established councils, Graph 3 (right-hand panel) shows the number of council members belonging to the central bank as a percentage of total council membership (abstracting from observers whenever this information is known).[4] The central bank is most often in the minority, particularly when the central bank is the prime supervisor or has an active supervisory role. It should be highlighted, however, that these numbers are based only on councils for which the membership could be established. In about one quarter of cases, membership is left open or has yet to be determined, which shows either that arrangements are not yet fully settled or that the authorities want to maintain a degree of flexibility in membership.

[3] Including the Council of Financial Regulators in Australia (1998), the Financial Institutions Supervisory Committee in Canada (1987), the Forum for Financial Market Supervision in Germany (2000), the Council of Financial Supervisors in the Netherlands (1999), the Financial Supervisors National Council in Portugal (2000) and the Tripartite Standing Committee on Financial Stability in the UK (1998).

[4] The total size of IACs varies widely, from (at least) two members in one of the groupings in Switzerland to 36 (plus 28 non-voting) for the European Systemic Risk Board (ESRB).

Chairmanship and central bank participation in IACs

Graph 3



Based on a survey of 40 central banks and monetary authorities.

[1] Or similar.

Source: BIS.

2.3.2 New internal committees

Since 2005, 11 central banks (about three tenths of respondents) have created at least one high-level internal committee focusing on financial stability issues. A few central banks have created more than one (eg the Bank of England, Bank of Thailand and Central Bank of Malaysia).

New top-level internal committees tend to have the same information exchange and coordination functions as IACs. They are sometimes supporting bodies – for example, the (recently disbanded) Financial Stability Committee at the Bank of England recommended overall strategy on financial stability matters to the Court, and the Macro Financial Committee at the Reserve Bank of New Zealand advises the Governor.

Top-level internal committees are usually headed by the Governor. As is the case with IACs, membership is not always precisely defined (eg top executives plus heads of "relevant" departments). It is worth noting that at a few central banks the top-level internal committees include varying degrees of external representation, either from the government or regulatory sectors, or from the public.[5]

2.3.3 New departmental structures and positions

Two thirds of responding central banks made changes related to financial stability in their internal divisional/departmental structures since 2005. Most involved the creation of one or more specialised units for financial stability or macroprudential

[5] At the Bank of England, the new FPC, which is a sub-committee of the Court of Directors, comprises four external members. At the Bank of Thailand, the Financial Institutions Policy Board includes five experts appointed by the Board. At the Central Bank of Malaysia, the Financial Stability Executive Committee includes not less than three but not more than five other members appointed from the directors or other persons.

policy. At many central banks, internal changes led to a stronger institutional framework for macroprudential oversight, including clearer mandates for the relevant units, a carving out of units into new specialised entities focusing on financial stability, or the elevation of such units within the internal hierarchy.

Since 2005, of the central banks in this survey, only the Bank of England and the Federal Reserve have created entirely new board-level positions with a prime financial stability focus (a Deputy Governor and a Vice Governor, respectively). But substantial adjustments to the responsibilities of existing high-level posts have been made in a number of cases, and there are several examples of new or substantially changed executive roles at the head of function/head of department level (but below the board level).

Appendix

Classification of the financial stability objectives found in the laws or statutes of 114 countries, as of December 2012

Table 1

1. An explicit financial stability objective exists in law		Central bank is obliged to consider the "stability", "soundness", "good order", or "efficient and effective functioning" of …			
		… part of the financial system (eg banking system, payments system)		… the overall financial system	
Objective appears to apply in principle to all the central bank's activities and functions (by virtue of being placed in the law's preamble or overarching statement of role, duties and obligations)	Objective unqualified (eg to "ensure", "guarantee", "maintain", "safeguard", "sustain" etc), except where stability or other macroeconomic policy objective (indicated by use of square brackets)	[Azerbaijan] Belarus	Libya [3]	Angola [BCAO] Botswana Cayman Islands China [Cyprus] Gambia [Georgia] Ghana Hong Kong SAR Iraq [Ireland]	[Malta] [Mauritius] [Moldova] [Mongolia] Montenegro Namibia [Philippines] [Tanzania] Thailand Uruguay Zambia [23]
	Objective qualified by being expressed in directional terms (eg "contribute to", "encourage", "promote", "support", "work towards", "with best endeavours" etc). Secondary objectives are again set in square brackets	[Albania] Argentina [Armenia]	Egypt [Germany] Sweden [6]	[Afghanistan] Aruba Bahrain Barbados [Belgium] Bermuda [Costa Rica] [Czech Rep.] ECCB [East Timor] Fiji [Finland] Guyana [Hungary] [Iceland] [Indonesia] [Israel]	[Kazakhstan] Kenya [Lesotho] [Luxembourg] [Macedonia] Malawi Malaysia [Mexico] New Zealand Nigeria [Poland] Singapore [Spain] [Slovenia] [Switzerland] [Turkey] United Kingdom Zimbabwe [35]
Objective is clearly attached to a specific function or task (eg licensing, supervision, lender of last resort)	Objective unqualified (eg to "ensure", "guarantee", "maintain", "safeguard", "sustain" etc)	[Bulgaria] [France] Jordan [Kyrgyz Rep.]	[Latvia] Lebanon [Morocco] Russia [8]	[Austria] [Bhutan] Chile [Estonia]	Jamaica Japan Nepal United States [8]
	Objective qualified by being expressed in directional terms (eg "contribute to", "encourage", "promote", "support", "work towards", "with best endeavours" etc)	[Croatia]	[Lithuania] [2]	Australia Canada [ECB] [Greece] Italy	[Korea] Macao SAR [Netherlands] [Slovakia] [9]
2. No explicit financial stability objective exists in law		Algeria Bahamas Bangladesh Belize Brazil Bosnia & H. Cambodia		Colombia Congo Denmark Guatemala India Iran Kuwait	Mozambique Norway Peru Saudi Arabia South Africa Trinidad & T. [20]

Source: National legislation.