# Nout Wellink: Central banks as guardians of financial stability

Speech by Dr Nout Wellink, President of De Nederlandsche Bank and President of the Bank for International Settlements, at the seminar "Current issues in central banking", on the occasion of the opening of the new office building of the Central Bank of Aruba, Oranjestad, 14 November 2002.

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It is a great honour for me to deliver a speech on the occasion of the opening of the new office building of the Central Bank of Aruba. This is an important milestone in the short history of this institution. Since its creation in 1986, the relationship between the Central Bank of Aruba and the Nederlandsche Bank has been very close. Those of you who are familiar with the Dutch weather will understand that this relationship is something we especially cherish during this time of the year. But there are many more reasons why our co-operation has always been fruitful, and will remain so in the future.

Indeed, although Aruba and the Netherlands have a different history and different traditions, our central banks have much in common. First of all, we both gave up much of our monetary autonomy a long time ago. The Aruban Florin has been pegged to the US dollar since its creation in 1986. Likewise, the Netherlands had pegged its currency to the Deutsche Mark since 1983. This fitted in a longer tradition of stabilising the Dutch guilder vis-à-vis the Deutsche Mark since the demise of the Bretton Woods system in 1971. Eventually, we gave up our own currency in 1999, to become part of the euro. A second common characteristic is that we are both small, open economies with a particular interest in a stable international financial system. While Aruba is an Offshore Financial Center, Dutch banks, insurance companies and pension funds have invested a substantial part of their assets abroad. Finally, a third similarity is that both our central banks have a broad range of activities. We are not only involved in monetary policy, but are also responsible for the prudential supervision of banks and some other parts of the financial sector. In this context, it is important to be open-minded organisations and to adjust to changes in the financial environment.

Seemingly, a new trend is that central banks increasingly present maintaining financial stability as their core task. A dozen or so central banks in the industrialised countries have launched a regular Financial Stability Review, and financial stability is often given a more prominent place in their organisation structure. Is this really new, or is it merely an explicit recognition of an activity that central banks have traditionally been involved with, albeit in a less visible manner? Central banks have always been involved in trying to preserve financial stability, for instance through their role as lender of last resort. In addition, a credible monetary policy aimed at price stability encourages confidence in the currency, which is a key element of a sound financial system. I think financial stability is now coming to the fore and is becoming more visible to the general public, mainly as a consequence of two major changes in the external environment of central banks over the past decades.

First of all, the financial landcape has changed. Until, say, twenty years ago, the financial sector was clearly segmented. There was a distinction between financial intermediaries and financial markets. In addition, there was a rather strict distinction between types of financial institutions: banks, insurance companies and investment funds. Domestic financial systems were to a large extent isolated from each other, because of capital restrictions and the virtual absence of cross-border mergers between financial institutions. Over the past two decades, this segmented structure of financial markets has largely disappeared. Financial institutions have expanded and increased their range of activities; mergers have taken place both across sectors and across borders; and financial markets have become much more integrated at a global level. As a result, cross-linkages have become stronger and there is a greater risk that shocks are propagated through the financial system.

Institutional developments are the second major change for central banks. These are closely related to changes in the financial landscape. In particular, the supervisory structure, which used to be organised along the same segmented structures as the financial sector, became increasingly obsolete. At the same time, international co-operation has become crucial, through international standards like the Basle Accord and more intensive bilateral co-operation between supervisors. In a number of countries, banking supervision has been integrated into broader supervisory frameworks. In the Netherlands, this is done by a very close co-operation between the Nederlandsche Bank, which is responsible for banking supervision, and the pension and insurance supervisor, PVK. In other countries, like he United Kingdom, supervision has even become the responsibility of a separate agency.

As a result of these trends, central banks have re-orientated themselves regarding their role in preserving financial stability. Personally, I am convinced that especially the banking sector remains of vital importance for financial stability, more so than other parts of the financial system. Given banks' pivotal role as both financial intermediaries and providers of payment facilities, problems with one institution can easily cause contagion effects. Central banks have an important task in mitigating these risks by offering secure payment settlement systems through which payments can be made in risk-free money. This also implies that central banks need to monitor their commercial counterparts intensively. At the same time, we cannot ignore the fact that commercial banks have become more exposed to other parts of the financial system, implying that our surveillance task should be broadened. For example, banks' increasing use of credit derivatives to transfer their risks to institutional investors, implies that these investors' ability to meet these financial contracts becomes a relevant factor. Let me elaborate a bit on this new development in central banking, and how we deal with it at the Nederlandsche Bank.

What do we mean by financial stability? According to our own definition at the Nederlandsche Bank, a stable financial system is capable of efficiently allocating resources and absorbing shocks, preventing these from having a disruptive effect on the real economy or on other financial systems. Also, the system itself should not be a source of shocks. Our definition thus implies that that money can properly carry out its functions as a means of payment and as a unit of account, while the financial system as a whole can adequately perform its role of mobilising savings, diversifying risks and allocating resources. Financial stability is a vital condition for economic growth, as most transactions in the real economy are settled through the financial system. The importance of financial stability is perhaps most visible in situations of financial *in*stability. For example, banks may be reluctant to finance profitable projects, asset prices may deviate excessively from their underlying intrinsic values, or payments may not be settled in time. In extreme cases, financial instability may even lead to bank runs, hyperinflation, or a stock market crash.

How can we safeguard financial stability? Although this concept is hard to capture by clear and observable targets, our definition of financial stability gives some clues. Let me mention three. First of all, potential sources of shocks need to be identified. Examples of shocks are interest rate hikes, financial crises in other systems, but also non-economic events like earthquakes and terrorist actions. Obviously, shocks are hard to predict, but having some idea of their potential magnitude is useful for making financial systems more resilient. A second factor to look into is the way shocks are transmitted to the real economy and to other financial systems. In particular, contagion and herding behaviour are important transmission channels. Elements to survey are the solvency and liquidity of different segments of the financial sector, the concentration of bank exposures, and problems that may arise due to a lack of information. The third issue, finally, is how the financial system's vulnerability can be reduced with policy instruments. Examples of such instruments are deposit insurance, supervisory guidelines, transparency codes and offering secure settlement systems.

A combination of responsibilities for monetary policy, payment and settlement systems, and prudential supervision makes a central bank particularly well-equipped for its role as a 'guardian of financial stability'. Our experience at the Nederlandsche bank shows that these three tasks are complementary. Vital information can be exchanged quickly within the same institution, which makes it easier to take appropriate actions if necessary. Furthermore, the three disciplines benefit from each others' expertise, which makes it easier to deal with complex problems. For example, macroeconomic analyses for the preparation of monetary policy may also be valuable for supervision, if banks have a large exposure on sectors in the economy with a weak performance. In addition, as financial market participants, central banks automatically obtain information about market sentiment and specific financial institutions, which is useful for their supervision task. By contrast, separate supervision agencies have to do without this direct source of information.

Let me give you a concrete example of how macroeconomic information can feed into supervisory practices. During the second half of the 1990s the growth rate of mortgage lending in the Netherlands accelerated to more than 20% per year. At the same time, house prices doubled in about five years. This was worrisome, not only because of inflationary risks, but also because excessive asset price inflation could eventually threaten financial stability. Specifically, there was a risk of a self-reinforcing spiral, with rising property prices leading to higher loans and vice versa, and with house prices departing from their intrinsic value. To get more grip on the underlying forces, the Netherlandsche Bank carried out an in-depth study among banks, based on both monetary and supervisory data. In this way, we obtained a clear insight in the development of bank lending criteria and other demand and supply factors, which made it easier to take appropriate measures in the supervisory field.

Specifically, we urged banks to improve their administrative controls and to carry out more stress tests to assess the vulnerability of their loans portfolios, and extended banks' monthly reports of their mortgage lending.

The terrorist attacks on the World Trade Center on September 11 last year again illustrated the benefits of having monetary policy, payment systems and supervision under one roof. This was a direct attack on the world's main financial center, and the stability of the international financial system was at stake. A prompt and adequate response of policymakers was crucial to mitigate financial stability risks. At the Nederlandsche Bank, we immediately organised a crisis meeting with our Governing Board and the heads of our departments of payment systems, supervision and monetary affairs. In the subsequent hours, we were able to take stock of the main potential problems in the payment systems, liquidity problems in the money market and the situation at Dutch banks. Together with the other central banks in the eurosystem, the Nederlandsche Bank provided a liquidity injection of almost 70 billion euro, which proved to be sufficient to help the money market clear. The close co-operation and direct information exchange between the Bank's various departments has truly facilitated the crisis management process. In this context, it should be stressed that the concerns that were at stake forced us to act quickly in a demanding environment characterised by uncertainty and risks of information shortages.

It goes without saying that changes in the financial landscape have strengthened the international dimension of financial stability. This is especially important for Aruba and the Netherlands, as we are both small, open economies. Given our economies' international exposure, we both have a key interest in a well-functioning, sound international financial system. Because the main Dutch financial institutions have become global players, shocks may come from many sources. This has made supervision more complex. Aruba's position as an Offshore Financial Center (OFC) has also implications for its supervision policy, given the increased international attention for OFCs.

In the past years, the international community has become more demanding towards OFCs. Of course, this is related to the fight against money laundering, tax competition and, most urgently, terrorist financing. Nonetheless, from the perspective of financial institutions there are legitimate reasons to use OFCs. Prime motives are low taxes and limited bureaucracy. There are also legitimate reasons for countries to develop an OFC. For Aruba, for example, it is an attractive way to diversify its economy, which is dominated by the tourism industry. In addition, historical factors make Aruba well-suited as an OFC. The country has a sound legal system, is politically stable, has a well-educated population and has relatively good airline and telecommunications connections. An OFC can also have a positive impact on the resident financial sector, through better access to international capital markets and more financial expertise. However, despite these advantages, many OFCs realise that they cannot ignore the growing concerns regarding their role in the international financial system.

Let me elaborate on the importance of OFCs for international financial stability. Note that in our definition, we defined a stable financial system as a system that prevents shocks from having a disruptive effect on the real economy, but also on other financial systems. The latter part of this definition has become more relevant as financial systems have become more interrelated. The importance of OFCs for international financial stability can be illustrated by a few figures. In the first quarter of this year, BIS reporting banks' claims against OFCs comprised almost ten percent of their total cross-border claims, creating a total risk exposure of almost 400 billion US dollars. These exposures are larger if off-balance-sheet activities are taken into account. In addition, insurance corporations and investment funds also use OFCs. Unfortunately, information on these off-balance and non-bank exposures is scarce.

Two years ago, the Financial Stability Forum identified OFCs as a weak spot in the international financial system. In particular, OFCs were spurred to strengthen their supervision and regulation frameworks and co-operate more intensively with the onshore authorities. Subsequently, the IMF has been asked to monitor the progress in this area, by carrying out Offshore Financial Sector Assessments. For Aruba, this assessment was completed in June of this year, and looks very encouraging. After all, only two years ago Aruba was classified by the Financial Stability Forum as one of the OFCs with legal structure and supervisory practices of a lower quality. Compared to other OFCs, offshore banks and insurance corporations are relatively unimportant in Aruba. By contrast, the large number of small, corporate vehicles is of particular interest. Actually, almost 5000 offshore corporate entities are registered on the island. Up to now, these were not supervised and not very transparent, and therefore represented a potential risk from a financial stability point of view. Following the IMF's recommendation, however, the Central Bank of Aruba will probably be appointed as regulator of this sector. In particular, the Bank will supervise Company Service Providers, which act as legal representatives of the offshore corporate entities. As a motivation for recommending the Central Bank of Aruba, the IMF stressed synergies with the Bank's other tasks. I agree. As I already indicated, at the Nederlandsche Bank we see important advantages of having various activities under one roof, and I am convinced that this new task will further strengthen the Central Bank of Aruba's position as the guardian of financial stability.

Ladies and gentlemen, let me conclude. Because of the rapid changes in the international financial landscape, central banks need to be flexible, indeed more flexible than in the past. By considering financial stability as their main responsibility, central banks should be able to take up new tasks. Both the Central Bank of Aruba and the Nederlandsche Bank have proven to be flexible organisations. As small, open economies, Aruba and the Netherlands are more vulnerable to external shocks and therefore have a particular interest in maintaining financial stability at a global level. Given this common interest, I am sure that the relationship and kinship between our central banks will remain as close as it has been in the past 16 years.