Mr Gjedrem focuses on the issue of financial stability: experiences and challenges

Speech given by Mr Svein Gjedrem, Governor of the Central Bank of Norway, at the annual meeting of the Norwegian Savings Banks Association, held in Sandefjord on 21 October 1999. (Shortened version)

1. Introduction

Every day around NOK150–200 billion change hands through the banks' accounts in Norges Bank. In the course of a week, payments corresponding to our gross national product for an entire year have passed through Norges Bank's settlement system. These payments involve all types of transaction, from a 10 kroner ice cream purchase to securities transactions where a single transaction may involve billions of kroner.

The banks play a pivotal role in the payment system. Deposits are now the predominant means of payment. Payment settlement is the banks' most important function besides channelling funds from savers to borrowers.

In other countries, securities markets are of growing importance. They are taking over an increasing share of banks' credit intermediation. This may also occur in Norway. Securities are also increasingly serving as collateral in payment settlement.

These three elements - payment and settlement systems, banks and other financial institutions, and securities markets - make up the financial system. Every day we experience how dependent a developed economy is on the smooth functioning of this system, i.e. on financial stability.

The volume of foreign payments is substantial and on the rise. Banks and securities markets are becoming ever more closely integrated. For better or for worse, we are increasingly exposed to developments in other countries.

The banking crisis taught us how costly financial crises can be. We brought the crisis on ourselves. Many other countries have experienced similar problems. The root of the crises can be traced back to overly zealous financial market participants with reduced risk awareness. The authorities' role is to prevent crises in the financial system and - if they still occur - handle them with a view to reducing the adverse effects and the likelihood of their recurring. In view of the globalisation of financial markets, international cooperation in this area is crucial.

The financial system is also important with regard to Norges Bank's conduct of monetary policy. By setting the terms for banks' deposits/loans in the central bank, Norges Bank influences the level of interest rates. Monetary policy is also dependent on financial stability. However, monetary policy is not the topic today. I will focus on the issue of financial stability.

2. What is financial stability?

Financial stability is the absence of financial crises. The root of a crisis is that exuberance, optimism and greed take precedence over risk and return considerations when investment decisions are taken. The price of financial assets and property rises. Bank loans and household and corporate debt increase. As a result, all agents become more vulnerable if the situation is perceived as taking a turn for the worse. This may in turn trigger a plunge in property and equity prices.

A stable financial system features solid cushions that reduce the risk of problems spreading from one institution or market to other institutions or markets, or across borders. This risk constitutes a systemic risk, i.e. the risk of failure of the financial system.

Disturbances that may develop into a systemic risk can be transmitted through financial institutions and financial markets. Stable institutions are solid institutions in which there is general confidence, whereas stable markets are markets where there are no “excessive” price variations.

The banks are in a special position. They transform short-term deposits into long-term loans. They are responsible for payment settlements, and bank deposits serve as a means of payment. The volume of amounts outstanding in the interbank market is sizeable. As a result, problems in one bank may rapidly spread to other banks. The financial strength of banks is thus important for financial stability. The more capital a bank has the larger the losses it can absorb. The risk of contagion is thus reduced. A bank’s capital adequacy ratio is not the only variable that must be taken into account. A bank’s earnings provide an indication of the bank’s future financial position. Another important factor is the size of a bank’s loss provisions.

Financial unrest spreads through payment and settlement systems. These systems can also be at the origin of risk. This occurs when banks credit customers before they have received settlement from the payer bank. The settlement of currency transactions is associated with a similar type of risk because settlement often occurs in different countries at different times. The latter risk is referred to as Herstatt risk, named after the German Bankhaus Hertsatt that closed in 1974. This occurred after the closing of the German settlement system, but before the matching settlement was finalised in the US. Other banks that had settled the German mark portion of the transaction with Bankhaus Hertsatt were running a loss because Bankhaus had not settled the dollar portion of the transaction in the US before it closed. The payment and settlement system must thus be designed to reduce settlement risk.

It is out of concern for financial stability that financial markets in general and banks in particular are regulated and monitored to a further extent than other industries. A bank failure will as a rule have more far-reaching consequences than a business failure in other industries. Both the contagion effects and the consequences for the real economy are greater. In most countries, the authorities have introduced measures to restrain banks from taking excessive risks in their quest for profit. Another important consideration reflected in regulations is the need for consumer protection.

Regulations can distort competition and weaken market discipline. For instance a bank’s creditor may choose not to assess the risk assumed by the bank because of the safety net established for banks. A bank may thus seek to increase the expected return by taking on higher risk without having to pay for this in the form of higher borrowing costs. Market discipline is weakened when operators are sheltered from taking the full consequences of their own actions. This is referred to as moral hazard. The authorities must regularly undertake a critical review of regulations to determine whether they are formulated with a view to achieving the overriding objectives at minimum cost.

3. Work on crisis prevention since the banking crisis

The lessons drawn from earlier banking crises are the primary means of preventing new crises. The debt crisis in the 1920s was at the root of the caution that continued to be exercised many years later. Operators are still cautious as a result of the banking crisis in the 1990s. The memory of earlier experiences fades over time. It is imperative to establish framework conditions that deter borrowers and lenders from taking excessive risk. The central framework conditions include effective legislation and regulations, a robust payment and settlement system, and effective supervision of institutions and markets.

The capital adequacy regulations are more stringent today than when the banking crisis erupted. Sound capital adequacy strengthens banks’ capacity to bear unanticipated losses. The size of the banks’ capital base also sets limits for lending growth. The capital adequacy requirements are being revised. This will also have implications for Norway.

The new Bank Guarantee Act is another important change to regulations. The Act provides for a deposit guarantee. The guarantee is limited to a maximum of NOK 2m per depositor per bank. This represents a tightening for savings banks in relation to earlier statutory rules. For commercial banks this provides clarification in relation to the practice that was chosen during the banking crisis when all deposits were covered even if they were not covered by a formal guarantee. In relation to rules in other countries, the deposit guarantee in Norway is very generous.

During the banking crisis, subordinated loan capital was not written down in the crisis banks, although the banks' guarantee funds and later the state had to provide support to ensure continued operations. Subordinated loan capital did not function as a buffer as intended. Under the new Bank Guarantee Act, this capital can, subject to certain criteria, be drawn on while the bank is still operating. This increases the real buffer capital. It also means that banks with insufficient capital, and banks that take excessive risk, have to pay more for subordinated loan capital. This boosts market discipline.

The risk of problems in one institution or a market segment spreading to other institutions or markets through the payment system is substantially reduced. A large share of interbank transactions is settled continuously during the day through Norges Bank's settlement system. The largest interbank payments are settled individually and continuously on a gross basis. This reduces the risk of crediting an account without the payment due being transferred. Before the settlement is finalised, Norges Bank verifies whether the banks have sufficient funds in their accounts in Norges Bank. The introduction of collateral requirements for banks' loans has lowered the risk assumed by Norges Bank.

Supervision has been substantially strengthened since the banking crisis. The Banking, Insurance and Securities Commission's resources have been increased. Greater emphasis is placed on on-site supervision. The methodology for document-based supervision has been improved. Internal control routines have been enhanced. International surveillance cooperation has also been strengthened.

In addition, the authorities have become more aware of the importance of monitoring the financial system. The aim is to identify emerging tensions and possible sources of system failure at an early stage.

4. Prevention work in Norges Bank

The work undertaken by Norges Bank to maintain financial stability can be divided into three areas of activity:

- continuous monitoring of factors that affect financial stability;
- work to reduce the risk in payment systems and increase their robustness; and
- assess the effects of monetary policy and economic policy in general.

Surveillance

Surveillance primarily consists of analyses of the relationship between macroeconomic developments and the financial strength of financial institutions.

Norges Bank's analyses are presented in semi-annual reports on financial stability, called "Financial Sector Outlook". Experience shows that effective surveillance requires more than monitoring the earnings and capital adequacy of banks and other financial institutions. Developments in other markets must also be monitored. Analysing the interaction between real variables and financial variables has been assigned high priority. In Financial Sector Outlook we evaluate how an array of factors affect the robustness of the financial sector.

The Report includes an assessment of the outlook for the financial sector. If Norges Bank is of the view that the situation requires the use of instruments others than those available to Norges Bank, this should be clearly indicated. Financial Sector Outlook is thus submitted to and discussed with the Ministry of Finance and the Banking, Insurance and Securities Commission. The report is made public and published in our quarterly report Economic Bulletin.

The analysis of financial institutions concentrates on the situation in the banking sector and main groups of institutions as it is Norges Bank's responsibility to ensure the stability of the system, and not individual institutions. From a macroeconomic perspective, however, it may be appropriate to monitor developments in the largest institutions as this could deepen our understanding of macroeconomic developments and the main trends in the financial sector.

Norges Bank's surveillance work is carried out in close cooperation with the Banking, Insurance and Securities Commission, which supervises individual institutions. The Banking, Insurance and Securities Commission also produces reports on a regular basis with assessments of the outlook for the financial industry.

I would like to highlight three structural features that have contributed to changing the risk outlook for the Norwegian financial system.

First: there are now a larger number of financial groups, which comprise banks, insurance and mortgage companies, etc. The size of these entities has increased the risk of negative systemic effects if problems should occur in one of them. On the other hand, size increases the scope for spreading risk.

Second: the number of foreign financial institutions in Norway has increased. They will normally operate in several markets and engage in a broader range of activities. They may thus be more resilient to a recession or a crisis situation in Norway than banks whose activity is confined solely to Norway. The risk of contagion to other institutions is thereby reduced.

Third: globalisation of financial markets means that events outside Norway feed through to the Norwegian economy faster and with greater force.

Payment system

As mentioned, several measures have been introduced to strengthen the payment and settlement system. At the same time, the volume of payments has increased sharply. The risk of problems in the banking sector spreading through the payment system has not been eliminated. A high-priority task of Norges Bank is to identify risks and, together with the industry, contribute to more secure and effective systems. It has also become increasingly important for our settlement systems to have good international links.

Interdependence of financial and monetary stability

The objective of monetary stability - which in Norway means exchange rate stability and low inflation - and the objective of financial stability are interdependent. High - and thereby in practice varying - inflation and unstable exchange rates can threaten financial stability through several channels.

First, it is more difficult to assess the risk of an investment project. Inflation makes it difficult to differentiate between a change in prices for a good or service and a change in the overall price level. It makes it more difficult to determine the discount rate to be applied.

Second, fluctuations in the inflation rate are often accompanied by interest rate variations. A sharp rise in interest rates can also result in substantial losses on financial assets such as bonds and equity. Loans that have been granted against collateral in the form of such assets are even more exposed to losses.

When rising inflation and inflationary expectations necessitate a tightening of monetary policy a crisis often ensues. In several countries the financial system has been on the verge of collapse during such a period of adjustment. This was the case in the US in the early 1980s and in the Nordic countries around 1990.

Financial stability primarily contributes to price and exchange rate stability by facilitating the use of monetary policy instruments. Unstable institutions and markets constrain the use of interest rates because tighter liquidity and higher interest rates may increase the uncertainty concerning the stability of the financial system.

Asset prices are an important linkage between monetary and financial stability. A surge in property prices with a risk of a subsequent fall threaten to undermine banks' collateral.

5. Crisis management

Analyses of the Norwegian banking crisis provide a positive assessment of how the crisis was managed. The IMF relies to a large extent on the solutions applied to the banking crises in the Nordic countries as a model for its proposals for resolving the current banking crises in Asia.

The division of banking crisis management into three elements has gained general acceptance in Norway. The first element is that the banks' earnings and capital shall serve as the first line of defence. This limits moral hazard. The second line of defence is the collective guarantee system for the banking industry. The third line consists of government resources that will be made available should the collective guarantee schemes fail to resolve the crisis. Liquidity support from Norges Bank is part of the third-line defence.

I would like to underscore the importance of the conditions that were attached to the capital injected by the government. The banks' share capital was written down to zero. A change in management was required and the banks' operations were subject to strict criteria. The approach was transparent and won broad political support.

The Bank Guarantee Act provides the private guarantee funds with a remit that extends far beyond paying guarantee amounts. It also provides for support measures to ensure that a member is able to honour its obligations and continue operations, and if necessary to transfer its activity to another bank. A very important part of the decisions concerning solutions to a financial crisis in a bank is taken by the guarantee funds. At least five of the board's seven members must approve such support measures. Five of the board members are appointed by the general meeting of the member banks, while the Banking, Insurance and Securities Commission and Norges Bank each appoints one member. Support measures require the approval of a majority of the members appointed from the member banks.

The decision to widen the remit of the guarantee funds was based on the experience of the Norwegian banking crisis. Supplying capital from the guarantee funds proved to be a "cheaper" and more effective means of resolving the crisis than referring the solvency problems directly to the authorities.

The government shall provide capital support when financial problems in financial institutions threaten financial stability. How this is to be done must be assessed when such a situation arises. During the banking crisis, the government injected capital through the Government Bank Insurance Fund. It has been announced that the Fund is to be discontinued. Generally, developments since 1992 have reduced the need for government intervention in the event of new crises in the financial system.

- The banks have more equity capital than earlier.
- The banks' guarantee funds accumulate a higher level of capital.
- The establishment of foreign banks in Norway and increased foreign borrowing by Norwegians in foreign banks has improved the distribution of risk.

In any event, the question of whether and when government support is to be provided should be unclear, and the conditions triggering support should be very strict.

6. Norges Bank's liquidity support

Ultimately, it is only the central bank that can secure the liquidity in the financial system, which is why it is called the lender of last resort. The classic example of a liquidity crisis is a situation where there is a rupture of confidence in the banking system. Depositors panic and shift funds to more liquid assets, primarily cash. The conventional formulation of the role of lender of last resort is that the central bank shall supply ample liquidity during the crisis - at a penalty rate - to illiquid but solvent institutions. In the Norges Bank Act this role is anchored in our responsibility for effective payment systems and our duty to exercise the traditional functions of a central bank.

This raises three questions:

- What instruments are available to Norges Bank?
- How does one determine whether an illiquid institution is solvent or not?
- When is financial stability in jeopardy?

These questions are highly interdependent.

Norges Bank can use several instruments in the event of a liquidity crisis. If a crisis affects the whole financial system, we can change interest rates and supply large volumes of liquidity to the banking system. Interest rate cuts of a total of 75 basis points in the US in the autumn of 1998 are an example of this type of liquidity supply. If there is no solvency crisis, the banks should be able to provide collateral for the liquidity provided. Thereby, the central bank does not have to increase its exposure and moral hazard, as defined earlier, is limited.

A monetary policy that focuses on the preconditions for exchange rate stability will also promote financial stability. By avoiding abrupt changes in interest rates and not setting interest rates at a level that creates inflation or at a level so high that this leads to a deflationary recession, one can prevent the onset or deepening of debt problems that may contribute to instability in the financial sector.

Should liquidity problems in one institution or only a few institutions occur, Norges Bank may provide loans on special terms. In the event of liquidity problems the question of whether an institution is also facing solvency problems arises. In practice, it is difficult to determine whether an institution is insolvent or only illiquid. The basic principle must be that Norges Bank shall not provide solvency support. Solvency problems should be solved by injecting private equity capital and by the guarantee funds. Norges Bank's liquidity loans are normally extended against collateral.

An important question is whether an illiquid bank is so large and important that it could represent a threat to financial stability if it is not provided with support. Banks that believe the authorities consider them to be too big to fail may assume excessive risk and their creditors may supply them with credit at a cost that is too low. For instance, if banks believe that the central bank will solve any liquidity problem, this will weaken their efforts to prevent such problems from arising - and if they occur, from solving problems in the interbank market. The use of credit on special terms in situations where financial stability is not threatened is associated with indirect costs. The situation must thus be carefully examined before loans on special terms are granted.

If it is widely known and recognised that if an institution's problems are confined to liquidity, it should be possible for the institution to raise loans in the market. A problem bank's creditors - often other banks - will in such a situation make their own assessment of the bank's solvency. In principle, it is not a foregone conclusion that the central bank and other authorities would be in a better position to evaluate an institution's solvency than its own creditors.

Implicit insurance schemes, which are in fact what loans on special terms are, may impair the effective functioning of markets and lead to excessive risk-taking among banks. It may take a long time before the costs come into evidence. In a crisis situation it is important to take into account the long-term benefits of not providing support such as better functioning markets and more appropriate risk-taking.

If the banking system has access to a large supply of unsecured credit from the central bank or other authorities, this may create problems in a crisis. The authorities will naturally have to place considerable emphasis on their own creditor position and thus reduce the emphasis placed on the considerations mentioned above. There is also a risk that the banks and guarantee funds will exploit this creditor relationship to reduce their own contribution to resolving a crisis.

This problem is of less concern in Norway today than during the banking crisis. First, Norges Bank's loans to banks are almost negligible. Second, collateral requirements apply to all the standard lending facilities.

The role of lender of last resort is not clearly defined. The central bank shall ensure financial stability, but in order to ensure that institutions do not take support for granted, there must be uncertainty as to what type of situation would trigger the role of lender of last resort and the instruments that would be used. This is often referred to as constructive ambiguity. In his annual address in 1988 the then governor of the central bank formulated the role as follows:

“However, should financial institutions find themselves in a position that could affect general confidence in the credit market, Norges Bank - cognisant of its responsibility as the central bank - is prepared to take such measures as are necessary to bolster market confidence in our financial system.”

During the banking crisis the division of responsibility between the government authorities and Norges Bank was clarified. If “necessary measures” prove to be solvency support, the guarantee funds, and as a last resort the government, shall provide such support. Norges Bank will of course play an active role in any situation where financial stability may be threatened. This role must be exercised in close cooperation with the Banking, Insurance and Securities Commission and the Ministry of Finance.

7. The current situation

Before I sum up, I would like to make some brief comments on today’s risk outlook.

During the turbulence in the autumn of 1998, investors fled to liquid and safe investments. The interest rate differential between safe and risky instruments widened markedly. The difference is still wide. This reflects uncertainty among investors.

The increase in interest rates in Norway in the autumn of 1998 led to a contraction in credit growth that was far too high at the time, particularly in the corporate sector. Investment started to fall. Even if debt servicing costs increased in the short run, the risk of even higher debt in the future was reduced. Interest rates have subsequently declined.

The financial position of households is solid, and as a group they will be able to bear higher interest rates. If households reduce saving because house prices rise, their vulnerability may increase. Some indicators show that house prices are in real terms at the peak level recorded in the 1980s.

Bank losses have been unusually low for several years. We expect losses to return to a normal level in the period ahead as a result of weaker cyclical trends. We have also seen an expansion in credit to “weak” enterprises. So far, we have not noted an increase in losses or non-performing loans. Nor have the banks increased loss provisions. The increase in long-term debt in high-risk enterprises would indicate, however, that loss provisions should be increased in the near future.

Over the last few years, banks have accumulated substantial short-term external debt. Although this debt has gradually been converted into more long-term debt, there is a liquidity risk associated with the debt. When banks encountered problems with refinancing their foreign debt during the banking crisis, Norges Bank intervened with support. As Norges Bank has done on previous occasions, I would warn the banks against assuming that this will again be the case if similar problems should recur.

There is some fear in financial markets that a liquidity shortage may occur around the year 2000 in connection with the Y2K problem. This is reflected in money market rates.

Norges Bank’s instruments are effective in terms of rapidly supplying large quantities of liquidity if this should prove necessary. The central bank will supply sufficient liquidity to the money market in connection with the year 2000, as we normally do throughout the year. Should it prove necessary to depart from the collateral requirement, a risk premium will be applied.

8. Conclusion

To sum up and conclude: Norges Bank places emphasis on promoting financial stability. As a result of the banking crisis, Norges Bank has strengthened its surveillance of the financial sector. In cooperation with other public authorities in Norway and internationally, we will contribute to developing framework conditions for financial institutions and financial markets that reduce the likelihood of future crises. A priority task is to enhance the resilience of the payment and settlement system in the face of a crisis situation.

It is still likely that financial crises will recur. In the last 20 years, three quarters of IMF member countries have experienced a banking crisis. Not even a perfectly healthy macroeconomic policy and the development of an effective supervisory system constitute a guarantee against crises if the banks fail to exercise sound banking. Herd mentality and over-optimism that are rapidly reversed seem to be a recurrent phenomenon. Systems and contingency schemes are therefore required to handle crises in order to limit the adverse effects and reduce the risk of recurrence. The most important preventive measure is to promote sound banking. Subject to the statutory rules applying, the responsibility for sound banking primarily rests with the banks themselves.