The Importance of Banking Supervision in Ensuring Financial Stability

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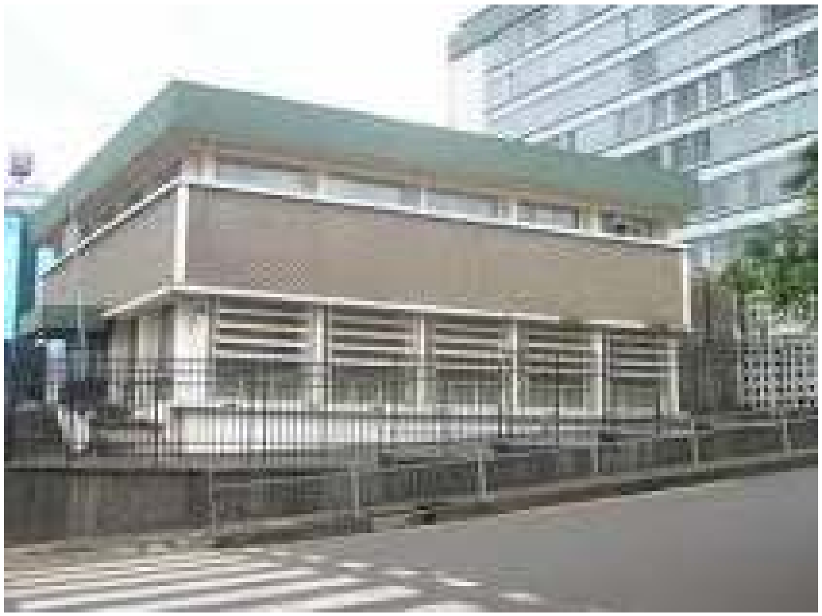
Outline of the Presentation

1. Financial Stability and the Role of Banks and Banking Supervision.
2. Some Causes of Financial Instability.
3. Managing Risks and Volatility.
4. Impact of Financial Crises.
5. Achieving Financial Stability.

Part 1:
Financial Stability & The Role of Central Banks and Banking Supervision



Definitions of Financial Stability

1. Key financial markets and the **financial institutional system is resistant to economic shocks** and is **fit to smoothly fulfil its basic functions.**

2. The ability to facilitate and enhance economic processes, **manage risks,** and absorb shocks.

3. The absence of system-wide episodes in which the financial system fails to function, **resilience of financial systems to stress**.

4**. Public trust and confidence in financial institutions**, markets, infrastructure, and the system as a whole.

BSL’s and BSD’s Stated Commitments

- **Mission:** To "formulate and implement monetary and **supervisory policies;** to **foster a sound economic and financial environment**.

- **Vision:** To "create a modern, **effective** and dynamic Central Bank that **serves the overall financial,** growth and development requirements.

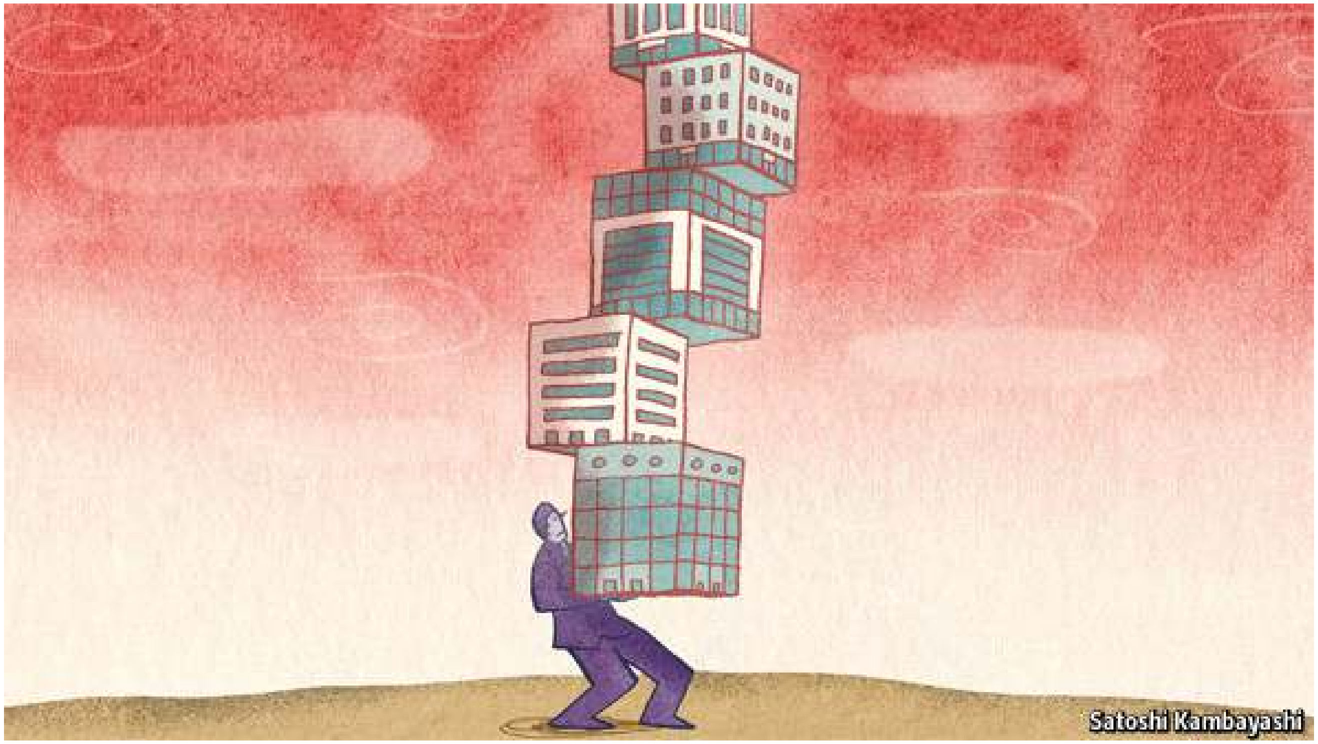
- **The BSD** has the responsibility of **licensing, regulating and supervising financial institutions,**

- The BSD …..In its functional responsibility of **ensuring a sound and stable financial system** …….

Roles in Financial Stability (Bank of England)

- reinforcing trust and confidence in money itself;
- acting as lender and market maker of last resort at times of financial stress;
- **promoting the safety and soundness of individual financial institutions**;
- **removing or reducing risks to the financial system as a whole;**
- **supervising financial market infrastructure**;
- **safely resolving failing financial institutions;**
- **collaborating with other financial authorities to support financial sector business continuity and operational resilience.**

Part 2: Some Causes of Financial Instability



What Gives Rise to Financial Sector Instability?

1. Unsustainable macro economic policies.

- Too expansionary fiscal and monetary policies,

Politicians spend and borrow excessively without worrying about the inter-temporal consistency of their fiscal plans,

- governments treat banks like captive market for public debt issues to finance deficits,

- Weaknesses in policy making processes,

- Central banks lack independence from political pressures.

What Gives Rise to Financial Sector Instability2?

2. Fragile Financial Systems.

More recently, financial weaknesses play a larger role than in previous crises due to:

- Banks dependence on short term debt
- Balance sheet vulnerabilities
- Currency mismatches- banks have assets in local currency and liabilities in foreign currency e.g. dollars
- Weak corporate and public sector governance
- Lack of a clear and credible limit on official safety nets to financial institutions.

What Gives Rise to Financial Sector Instability3?

3. Institutional Weaknesses

- Bank Managers and corporate CEOs are inadequately accountable to their shareholders and have inadequate incentives to manage financial risks,
- Government may deny regulatory authorities the autonomy needed for effective regulation,
- Insufficient shareholder and creditor rights,
- Ineffective corporate governance and financial transparency.

Weak governance allows excessive risk taking.

Part 3: Managing Risks and Volatility

Risk and Volatility

- Risks and Volatility are normal features of banking.
- Volatility helps convey decision-making information.
- Efficient markets react to information and are more volatile.
- Excessive volatility and risk taking are disruptive and costly
- Manage risk and volatility effectively do not eliminate!

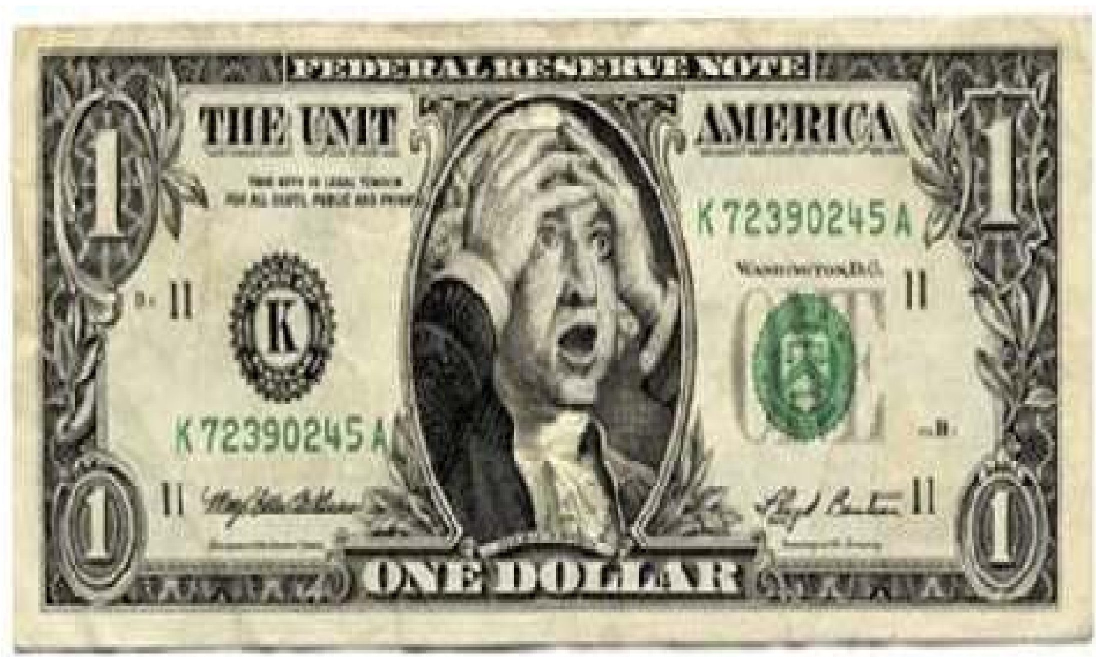
Research shows that countries where credit growth is relatively volatile tend to grow more quickly that those where credit growth is smooth and slow.

Supervisory Conundrum

- Countries without financial markets cannot have financial crises.
- Banks that are not permitted to borrow or lend will not fail!
- Suppress financial markets and transactions and eliminate banking failures and crises?
- Maintain strict controls on banks and allow limited scope for speculation and risks taking?
- Warning: policies that stifle financial development have adverse economic costs.

Enhanced Financial development => Financial Depth => rise in economic growth=> rise in incomes.

Part 4: Impacts of Financial Crises



Impact of Financial Panics

Financial panics are sparked by a sudden loss of confidence in one or more financial institutions, leading the public to stop funding those institutions, for example, through deposits.

Panics can cause:

- widespread bank runs
- restrictions on depositors' access to their funds
- bank failures
- stock market crashes
- economic contractions.

Social Indicators of Financial Crisis

Table 2. Korean Social Indicators Following the Crisis

	Divorces	Crimes	Crimes per 100,000	Drug Addicts per 100,000	Suicides
1996	79,895	1,494,846	3,282	6,189	5,777
1997	91,159	1,588,613	3,454	6,947	5,957
1998	116,727	1,765,887	3,803	8,350	8,496
1999	118,014	1,732,522	3,697	10,589	7,014

Source: Lee (2004).

Social Indicators of Financial Crisis2

Mathijs A. van Dijk Rotterdam School of Management, June 2013

Uses data on 187 banking crises in 126 countries , 1970-2009, and found that for the six years following a crisis:

- average life expectancy declines by nine months
- school enrolment drops by 3.5%
- fertility falls by 5.5%
- considerable short-run worsening of poverty and income equality
- 50% increase in outbound refugees and inbound foreign aid.

Part 5: Achieving Financial Stability

What have we learned?

- Effective regulation (and supervision) at the individual level (alone) does not assure a safe financial system
- The high degree of interconnectedness of financial systems and large scope for market failures means that a system-wide perspective is necessary for financial stability,
- Reducing the risks of a crisis requires a system perspective combined with a (macroprudential) toolkit,
- Proper functioning institutions are needed to assure necessary remedial actions.

What reforms are Needed?

- Adopt a system-wide view to managing the financial stability;
- Undertake needed banking system reforms such as higher capital and stricter liquidity requirements;
- Limit “too-big-to-fail” institutions;
- Improve regulatory governance;
- Secure better data;
- Derive information to reduce the unknown;
- Assume crises will occur/reoccur!
- Improve crisis management;
- Address the “this is different.” syndrome.

Contents

European Investment Bank

European Union

Foreign Affairs, Trade and Development Canada

Australian Aid

BSD and Working Together to:

- Ensure sound systems and management;
- Bring policies and practices in li
  international standards;
- Continue to build examiners' ex
- Appreciate the important role p
  ensuring Financial Stability;
- Actively participate in the FS co
- Share data, risks and concerns;
- Assess impacts;
- Take Action!

THE END!