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Rafiu O. Olaitan
Central Bank of Nigeria

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A Framework for Financial Stability* - Article Review

Rafiu O. Olaitan•

I. Introduction

The major objective of the paper was to assist central banks to properly answer questions bordering on designing a framework for their country's financial stability, which must be carefully analyzed and taken into consideration in designing the framework. Such questions, according to the author, include: How is financial stability defined and measured? How are financial instabilities changing? What are the appropriate instruments to achieve financial stability? Should prudential policy have a macroeconomic focus? And lastly, is there a workhorse model for addressing financial stability questions?

The author stated that this is apparently because of the links and deepening of policy by the central banks towards the attainment of financial stability.

II Major Highlights of the Paper

The author stated that there are varying definitions of financial stability in the literature stemming from the fact that the sources and nature of financial instability varied across time and countries. In his own definition, the author opined that financial stability entails a situation where a country's financial system makes it possible for individuals to smooth their consumption over time in the face of a shock, as well as, enabling efficient financing of investment projects emanating from the saved resources. On the other hand, the author stated that financial instability would arise from any deviation from optimal savings-investment, which might have resulted from malfunctioning of the financial system, which systemic risk is prominent. Systemic risk,

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•Rafiu O.Olaitan is a staff of the Statistics Department, Central Bank of Nigeria

according to the author, is a form of market failure and its stability possesses the characteristics of a public good. Therefore, systemic stability of a country's financial system, because of its cut-across provision, has been an anchor mandate among central banks. The author stated that systemic stability should be measurable in order to be effective, and that the potential sources of measuring systemic stability consisting of 'ex ante' before a shock struck the system and 'ex post' after the system had been shocked requires up-to-date, accurate and timely data on the activities of the financial institutions. The author posited that quantification of systemic risk relies on accurate data. He, however, stated that there are many financial stability data gaps and that data on financial institutions (especially off-balancesheet activities) are frequently partial and out of date. As such, the author acknowledged that there is no sufficient data for measuring financial stability.

The author noted that there have been significant changes in the precise nature and size of financial instabilities, particularly as manifested in systemic crises. The author identified the prime drivers for the changing form of financial instabilities as macroeconomic stability and the increasing integration and sophistication of the financial system. According to the author, these had accounted for the incessant speed, source and size of financial sector dynamics. The author observed that technological development had impacted tremendously on the processing capability - real-time online of activities in the financial sector; market risk are key consideration to the source of financial instabilities than credit risk and that the size of crises in the financial sector largely depends on the degree of diversification and hedging of risks across the markets, institutions and/or countries.

The author noted that instruments of financial stability differ from that of monetary policy in several fundamental aspects. The author identified instruments of financial stability to include central bank money, which is under the direct control of central banks, and transparency. The author noted that there is no consensus on when and how the central bank money could be used to achieve financial stability objectives. He stated that the impact of the central bank's instrument would depend on deeper understanding of financial instability by central banks. While acknowledging this limitation, the author identified other preventive policy measures, which the central banks could use to address systemic risks to include the design of resilient payment and settlement system; setting of prudential capital and liquidity ratios for financial institutions targeting Basel II capital standard provisions, as well as formulation of robust business continuity and financial crisis management arrangements for institutions and infrastructures, to dampen the effects of acute disturbances on financial activity.

On using transparency as an instrument of financial stability policy by central banks, the author opined that an ex-ante detection of, and transparent about, potential sources of financial instability would engender pre-emptive responses by market participants and possibly lower the impact of any crisis. The author stated that these had been the rationale by central banks in some countries such as Britain, Sweden, Hungary, Norway, Austria, Spain, Belgium, Denmark, France, Canada, Finland, Australia and, recently, ECB (European Central Bank) to start publishing Financial Stability Reports, to give their assessment of financial fragilities. The author, however, cautioned that issuance of such report on financial stability may trigger an unintended crisis, especially where the information contained were unfavourable to market participants.

Commenting on whether prudential policy should have a macroeconomic focus, the author posited that financial regulation could be likened to any other type of taxation meant to ameliorate market failure and, hence, fortify the attainment of macroeconomic objectives.

The author stated that there is no workhorse model for addressing financial stability found anywhere, and that efforts were being intensified at designing one based on the known potential sources of systemic risk, such as market or institution-specific shocks and common or aggregate shocks, which are already being considered separately. The author advised that any new-generation model should take into consideration characteristics and common shocks caused by financial instability.

III Comments and Relevance of the Paper

The author has undertaken an incisive study on one of the most pertinent issues on the core mandate of central banks, including the Central Bank of Nigeria (CBN), in any economy. The relevance of the paper cannot be overemphasized as the issue discussed is both topical and germane to financial sector developments in facilitating the realization of the core mandate of central banks. The strength of the paper lies on the various issues that were raised by the author and the underlying policy implications emanating therefrom.

Financial stability is as important as monetary stability in today's economic management and necessary for the promotion of sound economic growth. Although there seems to be a certain complementarity between price stability and financial stability, it is important to note that the achievement of the former does not necessarily mean the achievement of the latter.

The Asian financial sector crisis of the late 1990s and its contagion effects, and other countries specific financial sector crisis, including Nigeria, may have occasioned the need to develop a coherent framework for financial stability. The significance of having a sound and healthy financial system, therefore, cannot be over-emphasized. Irrespective of the definition given to financial instability in the literature, country experiences are varied. The Nigerian financial crisis in the banking sector of the late 1990s and early 2000s, have shown that financial instability occurred in varying forms and sizes in addition to its consequential implication for that country's financial system in general. The growing globalization and integration among world economies as well as the advancement in information and communication technology (ICT) has engendered greater improvement in the payment and settlements system of the financial system on one hand, and facilitated contagion effects of financial instability among countries - especially in the Asian crisis case on the other hand.

There is, therefore, the need for the central banks, including the CBN, to have deeper understanding of country-specific causes and nature of financial instability so as to facilitate the application of appropriate instruments to be used in order to curb its systemic implications in the financial system. As such, the Central Bank of Nigeria (CBN) has remained as the Chairman of the Financial Services Regulation and Coordinating Committee (FSRCC) to facilitate broader overview of various developments and vigorous surveillance of the financial sector of the Nigerian economy. In order to forestall another round of banking crises in the Nigerian financial sector, the CBN has been reviewing upward the capital base of the deposit money banks (DMBs) over the years. In 2004, the CBN initiated a bank consolidation programme that required all the DMBs to recapitalize to a minimum capital base of N25 billion by December 31, 2005. This led to a reduction in the number of the DMBs from 89 to 24 as at end-December 2007. The policy implication here for the CBN and any other central banks is to ensure continuous review of capital base of financial institutions as well as fine-tuning their respective surveillance activities in tandem with developments in the financial system because of the unpredictable nature of financial instability. These would also foster development of country-specific model that would, to a large extent, simulate variables for financial stability. However, a major challenge would be the development of deeper understanding of how the different dimensions of financial stability interact with each other and the real economy, as well as, their consequential influence on policy actions.

In line with the author's remark, transparency is core to the achievement of financial stability and forestalling any systemic crisis in any economy. The CBN, in its quest to ensure zero tolerance towards infractions and facilitate greater transparency, has deployed new information technology (IT) infrastructure such as eFASS (Enhanced Financial Analysis and Surveillance System) and RTGS (Real Time Gross Settlement System). This is expected to facilitate interface (operational processes and procedure) between the CBN and the DMBs. The publication of Financial Stability Reports by some central banks, as highlighted in the paper, is tailored towards the achievement of this objective but also portends negative implication for policy purposes. Based on the fact that the Report is anchored on transparency about an overview of a country's financial sector stability, the CBN is hereby advised to consider publishing Financial Stability Reports for Nigeria and also note that information contained in such a report has no implied interpretation so as not to further aggravate or create crisis expectation in the financial sector of the economy.