Toward a Framework for Financial Stability

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The following symbols have been used throughout this volume:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (for example, 1995–96 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (for example, 1995/96) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

"n.a." means not applicable.

Minor discrepancies between constituent figures and totals are due to rounding.

As used in this volume the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Preface

Financial globalization and liberalization have heightened awareness of the crucial interrelationships between macroeconomic policy and financial sector developments. The Fund has thus placed greater emphasis on financial systems in its consultations, policy advice, and technical assistance. This paper was designed as a first step in designing a framework that could be used to further its work in the surveillance of its members' financial sectors. As such, it draws heavily on existing work, particularly that of the Basle Committee on Banking Supervision, which has greatly contributed to the promotion of internationally accepted standards and practices for bank supervision. To aid further dissemination, the recently published "Core Principles for Effective Banking Supervision" are annexed to this paper. In addition, the Fund is greatly indebted to the comments of a large number of experts, both members of the Basle Committee and supervisory officials from emerging market countries, as well as to a number of other commentators. The framework also benefits from the research of the Fund and the World Bank, as well as experience gathered by both institutions in providing technical assistance and policy advice to their member countries. The Fund also acknowledges the support of the International Organization of Securities Commissions for permission to annex some of its work.

The paper was prepared under the general direction of Manuel Guitián, Director of the Monetary and Exchange Affairs Department, and Michael Mussa, Economic Counselor and Director of the Research Department. It was written by a staff team headed by David Folkerts-Landau and Carl-Johan Lindgren and consisting of Donald Mathieson, Richard Abrams, Bankhim Chadha, Daniel Dueñas, Gillian Garcia, Jan Willem van der Vossen, Laura Kodres, Michael Spencer, Peter Hayward, and other staff of the Monetary and Exchange Affairs and Research Departments. Sheila Kinsella, Lisa Scott-Hill, Lidia Tokuda, and Adriana Vohden provided expert secretarial assistance. Marina Primorac edited the manuscript and coordinated the production of this publication.

The paper has benefited from comments and suggestions from staff in other IMF departments, as well as from Executive Directors following their discussion of an earlier draft of this paper on March 28, 1997. The analysis, however, is that of the contributing staff and should not be attributed to Executive Directors or their national authorities.

I

Introduction

It is now well recognized that vulnerable and unstable banking systems can severely disrupt macroeconomic performance in industrial, developing, and transition economies alike.[1] The widespread incidence and the high cost of banking problems have prompted calls for concerted international action to promote the soundness and stability of banking systems. At the Lyon Summit in June 1996, the Group of Seven (G-7) industrial countries called for "the adoption of strong prudential standards in emerging market economies," and encouraged the international financial institutions to "increase their efforts to promote effective supervisory structures in these economies."[2] These intentions were reinforced by the IMF Interim Committee's "Partnership for Sustainable Global Growth" in September 1996 (see IMF, 1996). In Denver, in June 1997, the G-7 Ministers of Finance meeting considered a report by a Group of Ten (G-10) working party on financial stability in emerging market economies (G-10, 1997) and requested "the IMF and the World Bank to report to Finance Ministers next April on their efforts to strengthen the roles they play in encouraging emerging market economies to adopt the principles and guidelines identified by the supervisory community" (G-7, 1997). The G-7 Heads of Government then called "on the international financial institutions and the international regulatory bodies to fulfill their roles in assisting emerging market economies in strengthening their financial systems and prudential standards." The Heads of Government also welcomed "the IMF's progress in strengthening surveillance and promoting improved transparency. Increased attention to financial sector problems that could have significant macroeconomic implications, and to promoting good governance and transparency, will help prevent financial crises" (G-7, 1997).

International financial institutions and official groupings[3] are responding to these concerns in their respective work programs. The Basle Committee has been in the forefront of this effort with the release of its "Core Principles for Effective Banking Supervision." These principles have quickly become the focal point for the increased efforts to strengthen financial sectors around the world by providing a blueprint for enhanced banking supervision, and they provide the foundation for the framework described in this paper.

The IMF, with its near-universal membership, has an important role to play in this ongoing international effort. The IMF can help assure broad dissemination of the work of various organizations, particularly that of the Basle Committee. To this end, the "Core Principles" are attached to this paper as Annex I. Moreover, with its broad responsibility to engage in surveillance of member countries' economic policies, the IMF can assist in identifying potential vulnerabilities in the monetary and financial systems, and in the external positions of member countries, and it can help the authorities in formulating corrective policies.

The existing limitations on staff resources and expertise imply that an increase in IMF surveillance coverage of financial sector issues—as part of its ongoing bilateral or multilateral surveillance activities—will focus on identifying those weaknesses in the financial systems, particularly in the banking systems, of member countries that could potentially have major macroeconomic implications. Fund surveillance cannot be expected to address all the areas in the financial system that are in need of improvement, nor can it be expected to provide specific assistance to the regulatory and supervisory authorities in meeting their day-to-day challenges. Furthermore, in many member countries, banks remain the principal financial intermediaries for allocating and pricing credit and financial risk and for making payments, as well as being the main source of financial leverage. Hence, the IMF's efforts to enhance its work on financial system soundness will focus on the banking system, although attention will also need to be paid to those parts of the rest of the financial system that are potential sources of major difficulties.

Fund surveillance over banking sector issues of macroeconomic significance, and staff discussions on appropriate remedial measures with the authorities, will be enhanced and facilitated by a general statement of the broad principles and characteristics of sta-

[1]These issues have been extensively discussed elsewhere. See Lindgren, Garcia, and Saal (1996), and Folkerts-Landau and Ito (1995 and 1996).

[2]G-7 (1996).

[3]The Bank for International Settlements (BIS), the Basle Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS), the Group of Ten Deputies, the World Bank, regional supervisory groupings, and the IMF.

ble and sound financial systems. This paper suggests such a general framework, based on a generally agreed body of knowledge and experience. The application of this framework to individual countries will, of course, require careful consideration of country-specific circumstances as member countries' priorities for attainment of best practices will be different, based on their different traditions, existing structures, and resource constraints.

This framework is not a checklist of issues to be raised in each of the IMF's (usually annual) consultations with member countries under Article IV of its Articles of Agreement. Rather, it is intended to suggest broad categories of issues—and some detailed points within those categories—of particular importance for the discussion of financial sector issues of potential macroeconomic importance. Furthermore, consideration of issues in these broad categories, as part of the continuous process of Fund surveillance, can help identify circumstances where issues should be taken up with country authorities, sometimes on a more urgent basis than is permitted by the regular Article IV consultation schedule. Also, it is hoped that by promoting broader understanding of the requirements for sound banking and effective financial intermediation more generally, the development and promulgation of this framework—along with other similar efforts under way outside the Fund—may contribute to the general international effort to improve the soundness of financial systems, and thereby reduce the likelihood and diminish the intensity of future financial sector problems.

A number of official and industry groupings have for some time been compiling best practices, and formulating principles and guidelines, for use in the relevant sectors of the financial system.[4] The efforts of these groups, in particular those of the Basle Committee, have proved to be indispensable inputs into the formulation of the framework outlined in this paper.[5] As well as drawing on the work of the Basle Committee, the framework proposed in this paper has been developed in close consultation with the World Bank. The role of the World Bank in this area will complement and underpin the surveillance-oriented work of the Fund, in that its focus will fall on the microeconomic aspects of financial systems.

Although this paper describes in some detail the staff's distillation of widely accepted views on what constitutes such a framework for a sound and effective banking system, few, if any, of the Fund's members have banking systems that possess all of these characteristics. The guidance provided here is mainly intended to assist in maintaining the soundness of relatively large and complex banking organizations—specifically, those that are internationally active. While some of the principles are applicable to all banks, a simpler structure may be sufficient for smaller and less complex institutions. The focus in this paper is on institutions that have the potential to create systemic problems domestically or internationally.

Furthermore, some countries have in place an effective framework for a sound banking system that differs from what is described here. Nevertheless, the paper can be seen both as providing guidance for the direction in which supervisory structures and financial system reforms should progress, and as indicating some measure of the policy challenges that lie ahead. As noted earlier, the focus is on the banking system, the main financial intermediary in most Fund member countries, although there are also nonbank financial intermediaries and other elements in the financial infrastructure that make important contributions to the soundness of the system as a whole.[6]

As emphasized in Chapter III, neither external market discipline nor supervisors alone can assure a safe and sound banking system. It is the appropriate combination of the two elements that encourages the competent and effective management that leads to a sound banking system. Alternatively, when managers have sufficient incentives, buttressed by market discipline, supervisors can use a lighter hand. It should be noted, however, that in many countries management needs external guidance, yet supervisors face political interference and have insufficient resources. Moreover, markets are embryonic. Thus, improvements are required in all relevant areas.

These principles and practices have been drawn from a wide spectrum of sources. The work of the Basle Committee on Banking Supervision on prudential standards as compiled in the Core Principles has been an important source. In addition, the technical assistance work of the Fund and the World Bank has yielded a wealth of insights into what constitutes sound banking.[7] Furthermore, the experiences of supervisory agencies in some of the major industrial and emerging market countries have been useful in identifying principles and best practices.

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[4]See, for example, Annex II; the International Accounting Standards Committee (1997, 1994a, and 1994b); and Group of Thirty (1997).

[5]The Core Principles for Effective Banking Supervision (see Annex I), developed by a working group consisting of representatives of the Basle Committee and emerging market countries, have been a particularly important input.

[6]They include interbank payments and settlement systems; legal processes for the making and enforcing of contracts and the transfer of property, including the taking and perfecting of security for loans; and the workings of the judicial system so that banks have access to speedy and effective legal remedies. On payments systems see, for example, Folkerts-Landau et al. (1996).

[7]The Bank Supervision Guidelines issued by the World Bank (1992) and based on its extensive experience in advising countries on regulatory issues also have been an important influence on the development of best practices for prudential supervision in emerging markets.

Chapter II describes the role of the Fund in promoting financial stability as part of the ongoing broader international effort to achieve greater soundness in the financial systems of member countries. Chapter III describes the key aspects of the framework for a sound financial system discussed in more detail in subsequent chapters, that is, transparency of the financial system, public sector guarantees, prudential regulation, supervisory oversight, and supervision of cross-border banking.

Chapter IV examines the inherent difficulties encountered in compiling reliable and timely banking information. Best practices for the reporting of information to supervisors and for the disclosure of information to the public are described. Chapter V examines ways to limit the adverse impact on incentives that can arise when public sector guarantees and other official commitments are extended to bank depositors, creditors, and owners. There is a general consensus that safety nets need to be designed to work without unduly distorting the risk-taking behavior of bank stakeholders. The design of the components of a financial safety net—lender of last resort and deposit insurance arrangements—is discussed. The chapter suggests principles for the use of a strong exit policy for insolvent banks as a means to limit the extent of official guarantees and undertakings. Chapter VI presents a framework for prudential regulation based on the premise that regulatory restrictions on the activities of banks are needed to counteract the adverse incentives for risk-taking created by public sector commitments. The chapter discusses licensing policy, various qualitative requirements to strengthen governance, and the design and structure of quantitative prudential regulations.

Chapter VII presents principles and practices of prudential banking supervision. The focus is on the autonomy, authority, and capacity of the supervisor. The interaction of the bank supervisory authority with other supervisory and legal enforcement bodies is examined. The chapter also discusses practices of off-site monitoring and on-site inspection, and corrective and punitive measures available to the supervisor. Finally, Chapter VIII examines issues related to the supervision of cross-border banking. The focus is on the modalities of supervising the international activities of banks and on international coordination and cooperation in developing banking supervisory standards. The topics covered in this chapter include the location of licensing and lead supervisory authorities, the licensing of internationally active banks, cross-border exchanges of information, inspections, and sanctions.