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Bank of Japan

The Importance of Developing Financial Safety Nets and the Role of Central Banks

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I. Introduction

I am greatly honored and particularly delighted to have been invited to address this annual conference hosted by the International Association of Deposit Insurers (IADI).

Two years have passed since the global financial crisis triggered by the failure of Lehman Brothers. Authorities world-wide have made great efforts to contain the further deepening of the crisis and this process has confirmed the crucial importance of deposit insurance and other safety nets. However, at the same time, it has also become clear that there remain a number of issues to be addressed, in order to prevent any future crisis of such magnitude.

As deposit insurance plays a central role in financial safety nets, it is of utmost importance for senior officials of deposit insurance organizations and relevant authorities world-wide to have the chance to discuss first-hand and intensively among themselves the future of financial safety nets. This conference is one such occasion.

In my address today, I will talk about several issues which I believe are key to the development of effective financial safety nets, and about the role of central banks in maintaining financial stability.

II. Stability of the Financial System and Financial Safety Nets

Current International Discussions

Lively discussions are underway in various international forums as part of the effort to build a resilient financial system. The issues under consideration include (i) strengthening financial regulation and supervision, (ii) developing effective resolution regimes, (iii) raising the coverage limit of deposit insurance, and (iv) developing financial market infrastructures. All of these discussions are aimed, in one way or another, at preventing the failure of financial institutions and/or at containing financial crises. In this sense, these discussions all contribute to the improvement of financial safety nets in a broader sense, as they serve to protect the financial system from various kinds of shock.

Let me touch on some recent developments on these issues. With respect to financial regulation, a new framework for the quality and quantity of bank capital was agreed on in Basel last month. I believe the new standards are attainable for Japanese banks through efforts such as the accumulation of retained earnings, although the banks still need to improve their profitability as well as strengthen their capital bases.

One of the main tasks in the international forums hereafter is to deal with the moral hazard associated with systemically important financial institutions (SIFIs), in other words, the “too big to fail” problem. Specific measures to tackle this problem are under discussion at the Financial Stability Board (FSB) and elsewhere.

Regarding deposit insurance, temporary measures such as blanket deposit guarantees or raising coverage limits were introduced during the crisis in the United States, Europe, and a number of Asian countries. Some of these measures have been maintained and become permanent.

The Importance of Striking the Right Balance in Developing Financial Safety Nets

Although the development of financial safety nets is important, a wider and stronger safety net is not always the ideal. In order to maintain financial stability in the long run, striking the right balance is necessary in a number of areas. Therefore, I would like to talk further about some crucial issues in the development of financial safety nets, using “balance” as a keyword.

Balance between Stronger Regulation and Macroeconomic Recovery

First of all, balance is needed between stronger regulation and macroeconomic stability. The global economy has been on a moderate recovery path since the spring of 2009. However, balance-sheet adjustments in the United States and Europe are still underway, and many advanced economies are facing the zero lower bound on short-term interest rates, as well as the need for fiscal consolidation. Under these conditions, it is essential for us to be especially wary that the regulatory reforms currently under discussion do not undermine the recovery of the global economy as a whole.

Balance between the Development of Financial Safety Nets and Moral Hazard

Secondly, balance is needed between development of financial safety nets and limiting moral hazard. We obviously need to prevent the failure of financial institutions as much as possible and ensure sufficient protection for depositors in case a financial institution should fail. However, this should not be at the risk of inducing moral hazard, which could consequently destabilize the financial system in the long run.

As I mentioned, measures are being discussed to address the moral hazard problem associated with financial institutions that are regarded as being systemically important or "too big to fail", and therefore, considered to have implicit public support. Tackling the "too big to fail" problem also highlights the importance of balance in the context of curbing excess risk-taking by financial institutions, while ensuring market dynamism and encouraging innovative financial activities.

Having said this, we should consider some crucial points when contemplating measures for problems associated with SIFIs. First of all, if it becomes revealed to the market that a financial institution is to be treated as a SIFI, this could in fact induce moral hazard. In addition, looking back at the experience of Japan's financial crisis, whether an institution is systemically important or not depends on the condition of the financial system, and also on the effectiveness of the existing resolution regime. Furthermore, considering the essence of the moral hazard problem, the question of how to deal with SIFIs needs to be contemplated from various perspectives. For example, we need to take into account perspectives on containing the crisis as well as preventing it, and the balance between regulation and supervision. To be specific, capital surcharges should not be the only measure for dealing with SIFIs. There are many, not mutually exclusive, alternatives to capital surcharges, such as liquidity surcharges, strengthened supervision, and improvements in resolvability. I believe it would be appropriate for each country to choose the best practice from such measures or their combinations, depending on the environment surrounding its own financial system.

Balance in the Size of Financial Safety Nets among Jurisdictions; Need for Global Coordination

Thirdly, balance in the size of financial safety nets is needed among jurisdictions. With the globalization of financial institutions' operations, they have become more interconnected. Likewise, households now have more foreign assets such as foreign currency deposits and foreign bonds. These circumstances indicate the increasing importance of having a cross-border perspective when developing financial safety nets.

For example, regarding deposit insurance, a large-scale deposit shift between countries in Europe was observed in the fall of 2008 due to gaps in deposit insurance coverage. Some Asian countries raised their coverage limits in order to maintain the competitiveness of their banks. These examples demonstrate the importance of global coordination in the designing of deposit insurance.

Another issue revealed in the aftermath of the failure of Lehman Brothers is the need for a resolution regime that facilitates the orderly wind-down of failing financial institutions in a cross-border context. Obviously, each country's legal system depends substantially on its particular social framework, and convergence of resolution regimes is not easy. It is also not necessarily appropriate. However, it is becoming more important for authorities to have a good understanding of their respective resolution regimes and to communicate closely in the actual resolution process. In the aftermath of the recent crisis, the establishment of crisis management groups among supervisory authorities and central banks for internationally active financial institutions has been an important step forward in this regard. It is necessary for the authorities concerned to continue coordinated work on this issue.

III. The Role of Central Banks in Maintaining Financial Stability

The experience of the financial crisis has brought renewed attention to the role of central banks in financial safety nets, which in turn contribute to financial stability.

This has led to the assignment of macro-prudential roles and financial regulatory authority to central banks in the United States and Europe.

In this respect, the Bank of Japan has had an important role in both micro- and macro-prudential dimensions for maintaining financial stability. From a micro-prudential perspective, the Bank conducts on-site examination and off-site monitoring of a wide range of financial institutions including securities firms, and urges improvement in risk and business management when necessary. From a macro-prudential perspective, the Bank implements appropriate policy measures based on its analysis and assessment of the condition of the financial system as a whole by utilizing the information obtained from financial institutions as well as from the markets. Measures taken by the Bank from a macro-prudential perspective during the crisis include resumption of stock purchases held by banks, and provision of subordinated loans.

In this way, the Bank of Japan plays a critical role in maintaining the stability of Japan's financial system. The Bank will continue to make every effort, in both micro- and macro-prudential dimensions, to ensure and maintain this financial stability.

Thank you very much for your attention.