THE IMPORTANCE OF FINANCIAL STABILITY REPORTS FOR THE CENTRAL BANKS' FINANCIAL STABILITY FUNCTION

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Abstract: One of the obvious signs of increased interest in financial stablity is the growing number of countries that publish financial stability reports (FSRs). These reports offer an image on the way that Central Banks deal with the financial sector stability, how they foster it, what are the tools used in order to maintain it, how they measure it and what the impact of some risks is or could be on financial institutions and finally on population, hence ensuring the Central Bank's policy transparency and credibility. In this paper we analyze the reports published by different central banks with the aim to establish the common features that should characterize a good report that reaches its proposed objective, as well as highlight their importance for financial stability of a country.

Key words: financial stability, Financial Stability Report, objectives, instruments

Jel classification: G10, G20, E58

1. Introduction

The FSRs are meant to diagnose the way in which the recent evolutions of financial institutions, of the economy as a whole, as well as of the companies' and population sector, could affect financial stability. The risks associated with these evolutions are being analyzed through a set of indicators and, if possible and available, there are also stress tests carried out in order to directly measure the impact of possible shocks on the financial sector's solvability.

Martin Čihák (2006) defines the FSR as "regular, self-contained central bank publication that focuses on risks and exposures in the financial system". he also identifies some key elements that should characterize such a report, such as focus on risks, exposures and vulnerabilities in the financial system, systemic coverage, publisher (most FSRs are published by central banks), the self-contained nature and, the regularity of publication, as FSRs are regular (typically annual or semi-annual) publications, while a one-off report on the financial sector cannot be considered an FSR.

The first published reports can be traced back to the middle 90s in the UK and some Nordic countries. The number of countries that publish FSRs has rapidly grown from two in 1995 to fifty in 2005. This increase of the number of reports also coincides with the interest growth in financial stability issues. If we study the geographical area of the FSR publishing we could notice that Europe has the majority. In Romania the first FSR was published in 2006.

The FSR are being published not only by central banks and financial authorities, but also by some international institutions, like the International Monetary Fund. Together with the World Bank it has launched, in 1999 the Financial Sector Assessment Program (FSAP), offering countries an evaluation of their financial sector and of the regulation framework (IMF and World bank 2005). Čihák (2006) shows that most of the FSR published at the beginning of the program have been published by countries that accepted and started taking part in the program. Detailed assessments of observance of relevant financial sector standards and codes of each country, which give rise to Reports on Observance of Standards and Codes (ROSCs) as a by-product, are a key component of the FSAP. The IMF also publishes the Global Financial Stability Report that looks at the evolution of the financial sector from a global perspective.

The main reasons for which some countries have decided not to publish FSRs can be found in the fact that the problems of their financial sector are too delicate to be made known to the public. Secondly, the central banks have an incomplete control over the results of the policies carried out for financial stability fostering and, third, the publication of FSRs needs financial resources. Maybe this third point of view is also the reason why mostly countries with high to middle income publish these reports and fewer countries with low income. Even though these reasons seem pertinent, the importance of financial stability is more important. An example of its importance can be found in the financial crises in the last decades and, more importantly in the current financial crisis. Hence, central banks, or other financial authorities, if that is the case, should constantly monitor the evolution of risks to financial sector and publish periodical reports, in this way insuring the transparency of its actions to the public and, hence its actions' credibility.

The FSRs can contribute to financial stability through an improved understanding of risks that threaten financial institutions and through alerting both financial institutions and other market participants on the possible impact of their actions on the whole system. There has also emerged the need for educating the public on the costs of financial instability.

2. Objectives, characteristics and instruments

The FSRs can have a multitude of objectives that contribute ti financial stability fostering, subordinated to the final objective. The FSRs highlight the importance of monitoring and publicly presenting the evaluations carried out by the Central Bank, relevant to the financial sector. Some central banks see the FSRs as an instrument for promoting the cooperation between surveillance and regulation authorities and, others as an instrument for the clarification of the Central Bank's role in financial stability. Others see it as way to increase confidence in financial services, based on the permanent risk monitoring, through these reports. Bowen, O'Brien and Steigum (2003) suggest that FSR publication strengthens the surveillance's quality and discipline, at the same time proving that the Central Bank complies with its mandate. So, these publications can play an important role in improving Central Bank's transparency and credibility.

The aims can also be found in informing stakeholders of potential financial stability risks and ways to mitigate them, encouraging informed debate on financial stability issues, serving as an accountability instrument and, helping to provide information that major participants in the financial industry may use as part of the input into their own risk assessment procedures. Some central banks define the objectives of their FSRs according to the target public. An example is the Bank of England, which specifies the fact that the FSR is intended to those that have an interest in maintaining financial stability at a national or international level, to the academic world, to journalists and financial market participants.

Closely related to the aims of the FSRs is also the definition of financial stability. Most FSRs include different definitions of the financial stability For example, in the 2006 Financial Stability Report, the National Bank of Romania specifies that "central banks also have a well established role in financial stability, defined as a ability of the financial system to face systemic shocks, on a durable basis and without major perturbations, to efficiently allocate financial resources in the economy and to efficiently identify and manage risks."

Franklin A., Francke L. and Swinburne M (2004) propose some elements that should characterize a FSR in what regards its objectives and financial stability definition:

- Clarifying the definition of financial stability helps the reader, and in particular a first-time reader, to understand the FSR's statements on financial stability.
- Clarifying the aims helps the reader, and in particular a first-time reader, to understand why certain topics are covered or omitted in the FSR.
- The definition of financial stability should be a standard part of the report, presented consistently across reports.

- The statement of aims should be a standard part of the report, presented consistently across reports.
- Financial stability should be defined both in general terms and in operational terms.
- The aims of the report should be comprehensive.

The elements discussed in reports have diversified in time, along with financial system diversification and with the increased ability of the authorities to compile and analyze data. Most FSRs, at the beginning, have only focused on the banking system, in time also getting to present the nonfinancial sector, the payment systems, as well as the regulation framework. The attention given to the nonfinancial sector is rising, because companies and population are more and more seen as potential risk sources. More recently, the FSR have also started to focus on the activity of the nonbank financial companies, like insurance companies, pension funds, stock exchange intermediaries, that tend to gain a higher importance in the financial sector.

In what concerns the risk factors, the credit risk is presented in all FSR (Čihák, 2006), as the most important risk source. Many central banks also analyze the exchange rate risk and the risks derived from the payment and settlement systems. The interest rate risk and liquidity risk are also presented in almost half of the reports. Other less important risks presented are the country risk and contagion risk. The National Bank of Romania analyzes all of these risks and presents conclusions regarding them in its annual FSR.

The FSRs use a series of analytical instruments, which are usually useful to the macro prudential analysis. As compared to the traditional macro prudential analysis, usually used in inflation reports and in other more general reports regarding the economical development, these instruments are orientated mostly on the analysis of the balance sheets of the financial institutions, on extreme scenario construction, that include problems in the transmition mechanisms or multiple equilibrium.

The techniques used have diversified in time. All FSRs analyze macro prudential indicators, usually complying with the Financial Soundness Indicators promoted by the IMF. Identifying some macro prudential indicators and monitoring their evolution, represents a way to provide information regarding the risks to which the financial system is exposed. The variable set must contain a subset that tries to quantify[323] how well the finances facilitate financial and economic processes. Moreover, they must also take into consideration the fact that the nature of the systemic risks has changed and specific risks can be more concentrated than in the past. That being the case, financial and nonfinancial institutions have enlarged their activities, at national and international level and, hence, their risk exposure, while the risk protection and diversification instruments[324] have rapidly evolved. All these lead to the necessity of a large and explicit ser of indicators, which should provide two important categories of information, regarding economic and financial development (monetary, businesses, variation in the real price of assets) and regarding financial vulnerability (debt amount, asset quality, liquidity) (Heteş R., 2009).

Although the range of macro prudential indicators is rich, these only ensure a partly evaluation of the system's vulnerabilities, especially because *ex ante* identification of the growth of these vulnerabilities is still difficult and, for the moment, the measurement of these indicators remains imprecise. Financial stability analysis is complicated by unlinearities and the need to concentrate on exceptional, but plausible, events, often being necessary to take into consideration the evolution of variables and to assess what is happening if the risks take place simultaneously. Stress tests represent such an alternative, allowing the measurement of the elasticity of different parts of the economy in extreme conditions. The method itself has certain limits, in the way that, although stress tests can be made for individual financial institutions as well as for the whole

323 Even if not perfectly
324 securitization, swaps, credit risk trannsfer

banking system, using them at the level of the whole financial system is very difficult, a major problem being the lack of data.
Stress factors are associated with macroeconomic shocks that can intervene in the normal functioning of the financial system. The tests take into consideration vast shocks that can appear, but whose frequency of appearance is reduced[325]. The testing system tries to highlight the impact of different risks, with the help of different scenarios. The results of such tests show the sensitivity of a portfolio to particular shocks. The tests carried out on the system as a whole are different, being meant to identify common vulnerabilities for institutions, which can affect the stability of the whole financial system. The main advantage of such tests is that they allow the ex *ante* identification of vulnerabilities, as compared to an aggregate macro prudential indicator, that allows only an *ex post* evaluation of the financial vulnerabilities (Cerna et. al., 2008).

3. Financial Stability Reports' structure, frequency and availability

The structure of the FSRs differs from country to country. They usually start with the evaluation of the financial activity. First, risks are being presented at the international level, getting then to the national level. A problem that appears is that of the dimension that the international framework presentation should reach. If the available resources for an FSR are limited, then it can only highlight some important international and regional aspects, orientating its attention to elements of national interest.

There are also some parts of the report that repeatedly appear in each report and parts that appear only according to their importance to financial stability in the analyzed period. In our opinion the parts that appear in each repost should cover the main part of the report, leaving the other a more reduced part of up to 25-30%. This allows for diversification, as well as consistency. The common structure of a FSR consists of:

- Macroeconomic Developments.
- Financial sector infrastructure
- Developments in the financial sector
- Risks to the financial sector
- Special Topics
- Annexes

Table: Examples of FSR structures

Austria - ANB	France - BdeF
- Executive Summary - Reports - International environment (focused on CEE countries) - Domestic financial intermediaries - Domestic real economy and financial markets - Special topics - Annex (tables)	- Editorial - Overview - Summary - International environment and markets - Financial sector - Articles
Czech Republic - CNB	European Central Bank
- Summary - Macroeconomic Environment	- Overview of risks to financial stability

325 like the sudden drop in the economic growth rate, important deviations in exchange rates, or sudden drop in stock exchange indicators

- Corporate and household sectors - Financial sector - Financial infrastructure - Annexes	- Macro-financial environment - Financial system - Special features - Statistical annex
Finland - BoF	UK – BOE

- Summary, conclusions
- International operating environment
- Domestic operating environment
- The banking and insurance sector
- Infrastructure
	- Overview
	- Credit risk
	  - By regions
	- Risks in international financial system
	  - Markets, institutions
	- Domestic financial sector resilience
	- Selected issues

Germany - DBuBa	Romania - BNR

- Overview
- Macroeconomic outlook and risk factors
- International financial system
- Domestic financial intermediaries
- Legal framework and financial infrastructure
- Annexes
  - Indicators of international investors risk aversion
  - Stress tests
	- Overview
	- Macroeconomic international framework
	- Financial system and its related risks:
	  - Financial system structure
	  - Banking sector
	  - Nonbanking financial sector
	  - Capital market
	- Domestic macroeconomic risk
	- Companies and households
	- Annexes/Studies on financial stability

Source: Čihák M. – *How do Central Banks write on Financial Stability?*, IMF Working Paper, June 2006, and the National Bank of Romania website www.bnr.ro

An important aspect regarding the clarity of the reports is data availability. Through publishing FSRs there is an increased quantity of information available to the public, regarding the financial system. However, most of them are based on graphs and figures presented in text, with fewer statistical annexes.

An important part in the clarity of the reports is data availability. The publishing of FSRs increases the available information to the public regarding the financial system. However, most of them are based on graphs and figures presented in text. The use of numerical data could be useful to those with analytical inclinations, but, on the other hand would make the report too long and disorganized, with too much information, risking losing the key messages. One solution adopted by some reports is to present the numerical data separately, usually through appendices. In this way they insure an enhanced utility for the users of that information. Presenting numerical data separately diminishes the risk of losing the key messages that the report tries to highlight.

In what concerns the frequency of the reports, 29 central banks publish semiannual reports, 17 publish annual reports and one, Ghana, publishes such reports five times a year. In what concerns the length of the FSRs, it varies from 10 pages, in the case of Ghana, to approximately 220 pages for some annual reports. In Romania, the National bank of Romania publishes annual Financial stability Reports, with a variable length (121 pages for the 2006 FSR, 80 pages for the 2007 FSR and 95 pages for the 2008 FSR).

In what regards the availability of the FSRs they are usually made available to the public through the central banks' websites. They are also available in printing. In most countries the launch of an FSR is accompanied by media announcements, by announcements made through market analysts and sometimes through members of academic institutions.

4. Conclusions

In conclusion, we agree that the Financial Stability Reports are an important tool for fostering financial stability, but mostly for educating the public regarding the consequences of their actions on the stability of the financial system. The publishing of FSRs is one obvious sign of the central banks' increased interest in financial stability. Their aim is to offer an image on the way that central banks deal with the financial sector stability, how they foster it, what are the tools used in order to maintain it, how they measure it and what the impact of some risks is or could be on financial institutions and finally on population. FSR publication strengthens the surveillance's quality and discipline, at the same time proving that the Central Bank complies with its mandate. So, we could say that they play an important role in improving Central Bank's transparency and credibility. However, given the presented aims of the FSRs, they should also try to be as comprehensive as possible and their structure should comply with some unwritten rule, like the clarity of the objectives and measures, in order to ensure that the messages sent through them are correctly perceived by the public.

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