Financial Stability Reports:

How useful during a financial crisis?

Many countries outside the United States utilize financial stability reports (FSRs) to review the condition of their financial system, identify and assess risks to the system, and then suggest related changes in policy or financial behavior. These reports are generally produced by central banks and are issued on a regular basis.

In the aftermath of the recent financial crisis, Federal Reserve Bank of Kansas City Assistant Vice President and Economist Jim Wilkinson, Assistant Vice President and Economist Kenneth Spong, and Research Associate Jon Christensson examined these reports in their research article "Financial Stability Reports: How Useful During a Financial Crisis?" In their research, the economists reviewed the reports of four countries: the United Kingdom, Sweden, the Netherlands and Spain. They looked at whether the reports were effective in terms of providing useful information before and during the financial crisis.

Your research is about FSRs in a crisis environment, but what is their overall goal?

Wilkinson: Their focus is on providing insights into the condition of a country's financial system and its ability to withstand economic and financial stress. This information is intended not only for the central bank, but also for other financial supervisors and market participants. Optimally, the insights found in FSRs will enable all of these parties to better anticipate systemic problems and help design effective policy and market responses.

How many countries produce FSRs?

Christensson: About 50 countries produce some type of report. Although the Federal

Reserve and the other U.S. financial regulators have regular surveillance and monitoring programs, the United States is actually the only major industrialized country that does not produce an FSR.

What types of things do FSRs include?

Spong: They are all a little different, but generally an FSR looks at three areas: macroeconomic conditions or sectoral imbalances, financial sector risks, and international or external risk sources. And then within each of those areas, you evaluate if risks are increasing and if they are of a significant nature and likely to be realized. There are a lot of different ways to identify and measure risks. For example, a central bank might look at a wide range of indicators, including capital and asset quality measures at financial institutions, household debt levels, earnings and debt ratios for nonfinancial firms, and market-based indicators such as stock price information. Many reports also evaluate how the financial system and its stability would be affected if any of the risks they identify are realized. This analysis is often based on stress tests, or "what-if" tests. The specific information and analysis presented in an FSR will further depend on the economic structure of the particular country.

Did the FSRs see the crisis coming?

Wilkinson: The FSRs we reviewed generally did well in spotlighting the economic and financial trends that would prove to be so disruptive and threatening to financial stability. For example, some of the factors and trends the reports saw were highly indebted households, growing leverage in parts of the corporate sector, and historically low credit spreads and risk premiums on financial instruments. The FSRs also cautioned about the growth in complex and less-transparent financial instruments, rising interconnectivity among large institutions, and heavy reliance by financial institutions on short-term, wholesale funding sources, both domestic and foreign. Several FSRs also mentioned unsustainable housing booms; concerns over risks and imbalances spreading from the U.S. and U.K. financial systems; and, in the case of Sweden, the lending exposures that several banks had to slowdowns in the Baltic States.

It sounds like the FSRs had a good idea of where the economies were going, so why wasn't more done to prevent the crisis?

Spong: The reports made some strong attempts to measure how the risks they identified might affect their country's banking system and financial stability. For instance, the four countries constructed a number of scenarios and made assumptions about the channels through which these risks would be transmitted to the financial system. The countries then conducted stress tests to estimate the magnitude of the likely outcomes. These stress tests reflected such scenarios as a substantial increase in bank funding costs, a significant impairment in credit quality, the failure of a major financial institution in a country and a notable decline in housing prices.

Wilkinson: These stress tests appeared to be helpful in giving the central banks a better understanding of the resiliency of their financial markets and the type of responses that might

IN THEIR RESEARCH ON THE VALUE OF FINANCIAL STABILITY REPORTS in a financial crisis, Jon Christensson, left; Jim Wilkinson; and Kenneth Spong studied reports issued in four countries. Generally, the reports created by a nation's central bank are issued on a regular schedule.

be needed as the crisis continued. However, the stress tests and other analysis in the FSRs generally underestimated the magnitude and severity of many of the risks that were identified and evaluated.

Christensson: When looking at it, it is probably not too surprising that many of the countries affected by the crisis underestimated it, particularly given the unprecedented severity of the crisis and the fact that much of the crisis originated from events outside of several of these countries. Central banks must also be very careful to strike the right balance in writing FSRs and not overestimate the risks and threats to a country's financial system. You don't want to cry wolf every time, then eventually no one will believe you, or if they do, you might create a self-fulfilling panic. However, we believe that the warnings issued in the reports will most likely be given more attention now in the aftermath of the crisis, particularly in those countries where the reports identified many of the factors leading up to the financial collapse.

What comments have the central banks made about their FSRs?

Wilkinson: The FSRs and the central banks we studied had a number of insights that were helpful with regard to the challenges in writing and using FSRs.

As an example of the difficulties in judging risks, the United Kingdom in its 2007 FSR stated, "The speed, force and breadth with which these risks combined was not fully anticipated by the authorities or market participants." Also, Martin Andersson of the Sveriges Riksbank, Sweden's central bank, suggested that the formulation of FSRs is becoming more difficult: "The market dynamics have become more difficult to predict and market shocks have an increasingly rapid sequence of events."

Stefan Ingves, governor of the Sveriges Riksbank, discussed the challenge of getting supervisors and market participants to take appropriate steps when he stated, "When we look back, we must be self-critical and admit that we did not see the liquidity crisis that developed in the financial system in time. We did, however, issue repeated warnings about the development of risks in the Baltic countries and the fact that risk in general was priced too low on the financial markets. Unfortunately, our warnings in these cases were not sufficiently acted upon." Karolina Ekholm, deputy governor of the Riksbank, also spoke on this topic and mentioned several ideas for better coordinating the macroeconomic perspective of FSRs and the supervision and market responses of individual banks. One of Ekholm's ideas was "to link the work of Finansinspectionen (the Swedish financial supervisory authority) and the Riksbank more closely together and increase cooperation between the two authorities."

Would FSRs have made a difference if they had been used in the United States?

Christensson: I think the most we can say is that it is conceivable. For example, FSRs could have provided a more focused and comprehensive look at the risks and market imbalances that led up to the crisis here. Ideally, they might have given a clearer picture of the channels through which the crisis was moving and how it worked its way through markets and around the globe. There are obviously limitations, as we found in our study, such as with estimating the actual magnitude and the timing of the effects in a country. Overall, though, there are clear benefits, and some of these benefits go beyond anticipating or dealing with a crisis.

Such as?

Spong: There are actually quite a few, such as increasing transparency, assuming that you make the FSR publicly available. If that's the case, then it could help market participants better understand and respond to regulatory and financial stability concerns. It could also help by getting regulators—both domestically and internationally—to see what issues might be worth a little closer look. One benefit is that a lot of the work that regulators do, such as monitoring institutions, is highly confidential, and FSRs might be a way to share a little more of what we are seeing with the public. And then, it seems there would be major benefits to central bankers and regulators in just going through the exercise of examining financial trends and emerging risks. Other benefits could be derived from conducting regular stress tests and engaging in thoughtful analysis to gain insights into how resilient our financial system would be in an uncertain environment.

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BY TIM TODD, EDITOR

FURTHER RESOURCES

"FINANCIAL STABILITY REPORTS: HOW USEFUL DURING A FINANCIAL CRISIS?"
By Jim Wilkinson, Kenneth Spong and Jon Christensson
KansasCityFed.org/TEN

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