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Changes in monetary policy after the crisis – towards preventing banking sector instability

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Agenda

1) Introduction
2) Aim of the study
3) Identification of banking sector instability
4) Main pillars of response system of central banks on the banking sector instability
5) Summary
6) Literature

Main aim of the study

- is to identify the general framework of the response system of central banks on the phenomenon of banking sector instability, in the context of preventing it in a long term.
- Current - the traditional response system of central banks proved to be ineffective, because it did not prevent the spread of the factors that led to the destabilization of the banking sector.

Definition of financial instability

Researcher	Year of publication	Definition of financial instability
F. S. Mishkin (Mishkin 1999)	1999	Financial instability occurs when shocks to the financial system interfere with information flow so that the financial system can no longer do its job of channeling funds to those with productive investment opportunities.
E. Davis (Davis, 2001)	2001	Financial instability is a heightened risk of a financial crisis, which is associated with the collapse of the financial system, entailing inability to provide payments services or to allocate credit to productive investment opportunities.
R. Ferguson (Ferguson, 2003)	2003	Financial instability is a situation characterized by three basic criteria: ▪ some important set of financial asset prices seem to have diverged sharply from fundamentals, ▪ market functioning and credit availability, domestically and perhaps internationally, have been significantly distorted, ▪ aggregate spending deviates (or is likely to deviate) significantly, either above or below, from the economy's ability to produce.
J. Chant (Chant 2003)	2003	Financial instability are those conditions in financial markets that harm or threaten to harm an economy's performance through their impact on the working of the financial system.
W. Allen, G. Wood (Allen, Wood, 2006)	2006	Financial instability are episodes in which a large number of parties - households, companies or governments, experience financial crises which are not warranted by their previous behavior and where these crises collectively have seriously adverse macro-economic effects.

Source: Own work.

Banking sector instability

- **European Central Bank**: banking sector is unstable when it is not able to effectively allocate resources among the various sectors of the economy in a timely manner, properly assess and manage the risk or eliminate shocks.
- **J. K. Solarz and R. Kokoszczyński**: unstable banking system is unable to maintain financial liquidity, and individual banks are unable to cover losses and risks - which inseparably accompany their activity - from the equity.
- **National Bank of Poland**: banks are not efficient and solvent, do not have an appropriate level of capital to absorb losses and are characterized by inadequate liquidity to conduct its operational activity continuously and without any help from the outside.

Banking sector instability

- is the situation with the medium- and long-term liquidity problems of many banking institutions and a significant deterioration in their financial results, which precludes the appropriate functioning of the entire sector.

Charactieristics of banking sector instability

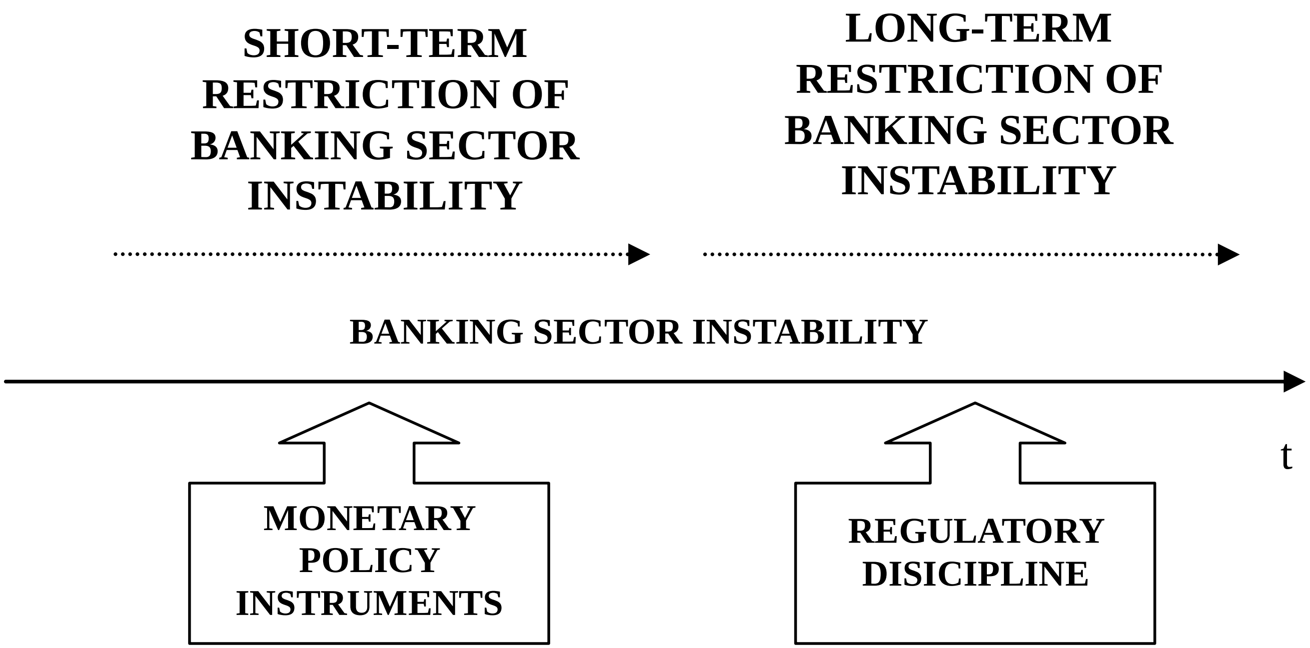
- problems of liquidity and insolvency,
- deterioration in generated financial result,
- decreasing their profitability,
- insolvency in the medium term,
- increase in receivables at risk in the loan portfolio,
- decreasing of capital adequacy ratios,
- high-leverage activities,
- significant increase in the volume of lending in relation to the deposit activity,
- increase in systemic risk,
- confidence crisis in banking sector.

Banking sector instability by various groups of bank's stakeholders

Unstable banking system by bank's management	• negative assessment of the financial statements and indicators characterizing its activity, the level of profit, total assets and capital
Unstable banking system from the viewpoint of shareholders	• lack or low level of paid dividends, the decline in stock prices, deteriorating image of a bank and its competitiveness on the market
Unstable banking system from the viewpoint of depositors	• low credit rating of banks, lack of confidence to interest payments, guaranteed in the agreement and to return the invested deposit, and also the lack of possibility of early payment of invested funds
Unstable banking system from the viewpoint of borrowers	• irregularity in meeting financial needs, high requirements for potential borrowers in creditworthiness assessment
Unstable banking system from the viewpoint of central bank	• lack of maintaining by commercial banks the appropriate level of equity, established in law regulations, as well as failure to meet prudential standards, set out by applicable law, including the law established by central bank and its authorities
Unstable banking system from the viewpoint of supervision authority	• failure to meet the banks' capital requirements and to adapt to regulations, imposed by supervisors at the national and international scale
Unstable banking system from the viewpoint of government	• inefficiency in meeting companies' financial needs • contagion effect, which causes that dysfunction is transferred also to other segments of the financial system, which also reduces the efficiency of the whole economy

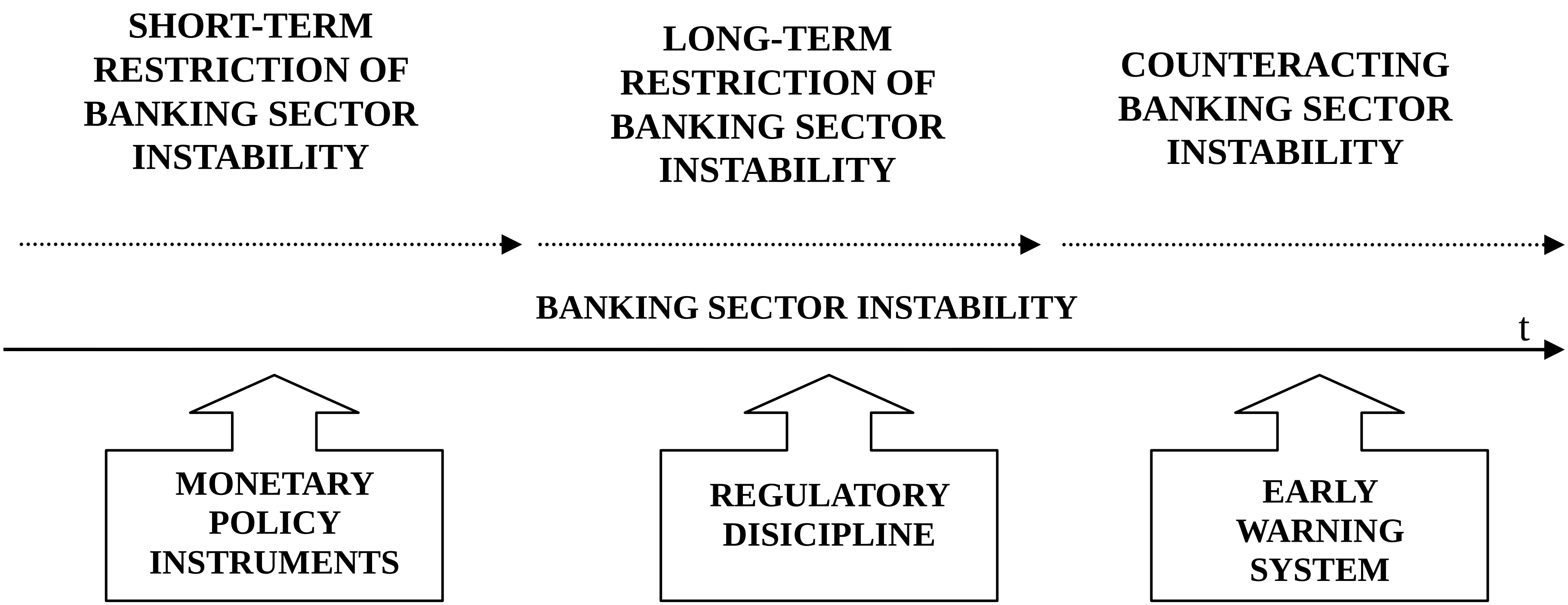
Source: Own work.

Traditional response system of central banks on the banking sector instability



Source: Own work.

Modern response system of central banks on the banking sector instability



Source: Own work.

Early warning system

INDICATORS OF BANKING SECTOR INSTABILITY

- **Credit risk indicators**
- **Indicators of the condition of the banking institutions**
- **Indicators of the condition of the banking sector**
- **Systemic risk indicators**

Source: Own work.

Summary

1) The global financial crisis has revealed the need to search for changes in the conduct of monetary policy.
2) Growing number of threats requires undertaking new methods or activities, which may be a form of predictors for central banks, warning against possible risk.
3) The study presents a proposal of response system of modern central banks, which would constitute a useful tool for monetary authorities to prevent and reduce the phenomenon of banking sector instability.

Summary

4) The modern response system creates a new paradigm of central banking, in which the institutional and instrumental framework of monetary authorities go beyond the traditional understanding of the functions of central banks, strongly associated with prevention activities, as well as regulatory and supervisory initiatives.

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