Jean-Claude Trichet: Worldwide tendencies in financial systems

Speech by Mr Jean-Claude Trichet, Governor of the Banque de France, at the Joint Bundesbank/BIS conference on "Recent developments in financial systems and the challenges for economic policy", held in Frankfurt, 28-29 September 2000.

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Ladies and Gentlemen,

It is a pleasure to seize the opportunity of this conference organised upon the joint initiative of the Bundesbank and the BIS to present a few considerations on worldwide trends in financial systems.

It is clear that the shape and operating modes of financial systems have undergone far-reaching changes under the combined impact of the marketisation and globalisation of our economies.

These developments were driven by two key factors:

- financial deregulation, reinforced in Europe by the setting up of Economic and Monetary Union, which enabled the free circulation of capital flows and the creation of competing financial sectors;
- technical and financial innovation, which paved the way for the creation of financial markets that are deep, liquid and interconnected.

Today, new trends are emerging in financial systems, and their consequences for monetary policy in particular and financial stability in general need to be examined.

I shall therefore discuss the following three aspects:

- first, the trends currently shaping financial systems;
- second, their consequences in terms of efficiency and stability;
- third, their impact on the action of central banks and prudential authorities.

1. Financial systems are being transformed by four driving forces.

First: intensifying competition between financial institutions

Whereas financial institutions formerly operated in separate segments of closed economies, they must now *compete in financial markets with other financial institutions, both domestic and foreign, regulated and unregulated*, as in the case of pension or hedge funds.

Financial innovation puts incessant competitive pressure on the providers of financial services which were formerly clearly distinguishable. Credit institutions, investment firms and insurance corporations increasingly offer products that have some similarities in terms of yield or hedging and thus find themselves competing for overlapping customer bases.

Competition between financial sectors has also increased in step with technological advances, which have enabled the emergence of new players in the financial sector. E-traders and e-brokers are challenging the dominant positions of banks and brokerage firms. The service providers for outsourced activities peripheral to financial business, such as back-office or custodian services, are also becoming increasingly important. In the future, Internet access providers or telephony companies may well become fully-fledged financial players in their own right.

Second: stiffer competition between markets

The development of information technology and telecommunications has allowed economic agents to move their capital at will. As a result, their investment and borrowing decisions are based on the opportunities available on all markets.

- Domestic exchanges have become mere compartments of the global market and find themselves competing with each other.
- Exchanges must also compete with the extraordinary expansion of over-the-counter markets. The largest financial institutions are big players on these markets, which operate according to private and decentralised mechanisms. Total notional liabilities on OTC derivative markets rose from USD 72,000 billion in June 1998 to USD 88,000 billion at end 1999. The average daily turnover on these markets increased by 50% between April 1995 and April 1998.
- Users' desire to improve efficiency has also driven the evolution in market structures. Planned links between stock markets, particularly in Europe, and the consolidation of delivery-vs-payment systems testify to these concerns. Domestic trading floors with regular working hours are gradually giving way to electronic international markets open around the clock. And the official trading systems of the various financial centres are in turn being challenged by private trading systems such as Electronic Communication Networks.

Third: new demands for transparency and profitability in the financial industry

Spurred on by this competitive pressure, the principles of corporate governance and value-adding have taken root, in particular under the impetus of fund managers. These principles force players to meet new requirements in terms of transparency and profitability.

Such requirements encourage participants in the global market to adopt new investment behaviour, in particular with the spread of index-linked management or massive recourse to leveraging.

These objectives also result in the use of fairly homogeneous risk management techniques, such as the definition and use of limits, risk management with value-at-risk models and the development of stress testing.

In addition, these objectives have established the importance of rating agencies for financial institutions, both in determining the conditions of their funding and in defining the structure of their portfolios.

Fourth: restructuring to cope with this increased competitive pressure

If they are to survive, traditional financial intermediaries must expand and/or innovate.

- The current consolidation of the financial industry is driven by the search for market power and/or economies of scale. Mega-institutions emerge, more and more internationalised and diversified. These developments give rise to financial conglomerates aiming at economies of scale.
- Product or process innovation is an alternative - or complement - to the search for a size effect. It can translate into a variety of strategies: developing new products to exploit market niches, entering into partnerships with other service providers - financial or not - in order to consolidate market share, or developing remote service offers to attract new customer segments and cut costs.

In Europe, the pace of this restructuring is accelerated by the euro.

2. These various trends have three consequences for efficiency and stability

The first consequence: improved macroeconomic efficiency in financial systems

Free capital movements, interconnected markets, the integration of market segments and the hedging opportunities provided by the new financial instruments allow a better fit between the financing capacities and borrowing requirements of general governments, households and companies. Market interest rates, which represent the markets' consensus on the risk incurred, are fully beneficial to the efficient allocation of capital.

Lowering the barriers to entering the financial sector, the free circulation of information and fiercer competition have also brought financial markets closer to a situation of perfect competition, which is of benefit to all consumers.

Lastly, the growth of market financing has allowed savings to be channelled directly into investment. Reducing the share of bank financing, and therefore to a certain extent that of money creation, has enabled the financing of the economy to be less inflationary.

Second consequence: a new framework for conducting monetary policy

Financial deregulation has contributed to change the conduct of monetary policies.

More open economies and greater interdependence between financial systems has completely overhauled the context in which monetary policy is implemented.

- Financial markets can now penalise inflationary monetary policies by withdrawing capital, with a subsequent rise in long-term interest rates and/or depreciation of the exchange rate.
- At the same time, the monetary policy transmission mechanisms have become more diversified and complex.

This situation is one of the reasons why there has been a substantial clarification at a European and global level of the division of labour amongst economic policies. In this context, monetary policy has been clearly assigned the objective of maintaining price stability.

Today, monetary policies are conducted within a framework characterised by two main features:

- Firstly, the reducing of inflation expectations depends on compliance with a number of rules that have been clearly defined in advance. Consequently, this policy can only be effective if the authority responsible for defining and implementing is credible. The conjunction of a clear, overriding objective of price stability (which has been explicitly laid down in the statute of the ECB), with well-established institutional independence ensures the continuity of the monetary policy decisions made by the authorities.
- Secondly, the emergence of a globalised market has quite naturally led to new developments in monetary policy instruments. Interest-rate instruments have gained in importance to the detriment of quantitative and regulatory instruments.

Third consequence: renewed set of risks to the stability of financial systems

First of all, it is worth noting that financial liberalisation did not eliminate the occurrence of financial crisis.

The development of new financial instruments, increasingly mobile and rapid capital flows, and faster reactions on the part of the players have rendered markets more volatile. Moreover, stock market prices and interest rates in the various financial centres have become closely correlated due to increased arbitraging between currencies and financial products and the spread of disintermediated financing.

In fact, the last two decades have experienced a string of financial crises:

- banking crises in the United States at the end of the 1980s, in Scandinavia at the beginning of the 1990s and subsequently in the rest of continental Europe and Japan;
- the 1987 stock market crash;
- the bond market crisis of 1994;
- currency crises in the emerging economies, in Mexico in 1994 and more recently in Southeast Asia from 1997 onwards, which spilled over into Russia and Latin America before spreading to the industrialised countries, as illustrated by the default of the LTCM fund.

Secondly, the trends at work in financial systems have triggered new threats of distortions throughout the markets.

The interplay between participants' expectations, their self-fulfilling nature and market spillover pave the way for the emergence of possible financial bubbles. These bubbles are frequently fed by easy access to credit as well as the use of instruments with a high gearing effect. Imbalances may thus arise and, in certain cases, be protracted. The current uncertainty regarding the valuation of new technology stocks is a prime example of this problem.

The standardisation of risk management methods and the resulting herd instinct on the part of market-dealers brings with it a number of disadvantages, such as liquidity shortages on certain market compartments, which lead to more volatile prices, credit rationing for certain borrowers and micro-financial contagion whereby "innocent victims" bear the brunt of imbalances stemming from other economies.

Such risks have become greater with the development of over-the-counter derivatives markets, which are a potential source of instability for the overall financial system. Liabilities are generally financed with credit, they are based on asymmetric information and risks are concentrated on some of the largest global financial institutions.

These institutions may also be tempted to take *excessive risks* when they come under pressure from heated competition and shareholders' demands for value. Of course, the prudential authorities approve of high returns on equity, but systematically aiming for returns on equity of 15%, 20%, or more while world growth averages 3% to 5% could make institutions more vulnerable. Actually, the search for profitability should not induce institutions to resort to extreme gearing in which debt replaces capital, or distort portfolio structures by undue focus on high-yield financial assets which also entail a high degree of risk. Nor should it lead them to curtail operating costs excessively, thus reducing the resources devoted to internal control. On credit markets, the financial position of banks can also be seriously jeopardised if they are tempted to reduce margins drastically in order to maintain or increase their market share, or if they make insufficient provisions during cyclical upturns.

More generally, some of the most widespread *management methods* are not entirely without risk:

- The accounting practice of marking-to-market most of the assets in credit institutions' balance sheets renders them more vulnerable to price fluctuations. The spread of market valuation through the concept of "fair value" could make banks' total assets and profits highly volatile. This is why French prudential authorities have reservations about this method.
- In the same vein, the Asian crisis has highlighted the limits of systematically resorting to rating agencies, which can reinforce the herd behaviour of markets. These ratings, which can never be perfectly accurate and up-to-date, should be taken for what they are: just one of several instruments for risk management.
- The turbulence surrounding the Asian crisis also clearly showed that the models used for managing complex derivatives do not adequately take into account abrupt gyrations in one or several markets.

And lastly, the public authorities must meet new challenges.

- In general, the default of the LTCM fund in September 1998 underscored *the risk of contagion* between financial systems. However, the resolution of the crisis demonstrated the ability of the monetary and prudential authorities to undertake effective, coordinated and pre-emptive action which prevented it from turning into a full-blown financial crisis.
- The increase of bond markets, shorter durations for interbank financing and the growth of derivatives [such as structured bonds with index-linked yields] challenge *the involvement of the private sector* in the resolution of international financial crises.
- The *process toward larger and more complex financial institutions calls for particular attention from the supervisory authorities*. The institutions born of mergers should not incur excessive risks because they feel that they would be "too big to fail". More generally, we have to be aware of some potential dangers of this race for size. It may lead to oligopolies. An oligopoly is not a desirable situation for at least two reasons: first, it could distort the allocation of capital, and second, it could increase the instability of financial systems. However, the risk of an oligopoly may be mitigated by the presence of new entrants in the financial sector, which reflects the fact that the market remains contestable.
- The implementation of traditional prudential regulations is complicated by the growing importance of *non-regulated participants*, such as highly-leveraged institutions which have close links with regulated institutions, and the spread of innovative distribution channels, mainly in the field of remote financial services.

In sum, the recurrence of financial crises, the emergence of market distortions and the new challenges facing supervisors have prompted some analysts to wonder whether there would exist a dilemma between efficiency and stability. Is instability the price to be paid for the improved efficiency resulting from financial deregulation? Allow me to present now the answers I think central banks and prudential authorities could give to these questions.

3. Monetary and prudential policies should promote an environment in which financial systems are both stable and efficient

First, monetary policy should act as a stabiliser

Monetary policy alone cannot guarantee the stability of financial systems, which may be jeopardised by shocks from both the financial and the real economies. However, it does have a stabilising effect. In general, the objective of price stability lowers economic agents' uncertainty regarding future price developments. In addition, by committing itself to a long-term objective, the central bank reduces market uncertainty, which can be a source of disruption to the financial economy. Interest rates are less volatile as a result, which is of benefit to the long-term growth of the economy.

To achieve this, the central bank must send clear and consistent signals to agents and markets and maintain a constant exchange of information. Financial innovation and the liberalisation of capital movements have made such communication more sensitive. Central banks must now systematically explain discrepancies between actual and projected results if they are to preserve their credibility.

However, for financial systems to be stable, monetary policy must be consistent with the other aspects of economic policy, that is, fiscal policy and structural programmes. The policy mix must be well-balanced at the international as well as the domestic level. Placing too heavy a burden on monetary policy in terms of achieving the main economic and financial balances is detrimental to its effectiveness. In particular, it diminishes its ability to maintain and consolidate financial market stability. This concern underlies the implementation of the Growth and Stability Pact in Economic and Monetary Union. By obliging fiscal policies to commit to stability, the pact allows the fiscal buffers to fulfil their role as stabilisers.

Lastly, one must also take into account the fact that, by their information and expectations, investors can penalise imbalances affecting the main world economies or diverging developments in different countries. To reduce this constraint, economic and monetary policies must be harmonised at the international level in order to achieve more balanced international financial relations.

Second, prudential policies should try to reconcile efficiency and stability in financial markets

I would like to insist on three objectives I feel are fundamental to promoting efficient and balanced financial systems.

Supervisors' first objective should be to monitor the soundness of financial institutions

To do so, they must work at two levels.

At the micro-prudential level, they must ensure that the restructuring of financial systems is well-balanced and that the merged institutions are healthy. Similarly, they must focus on promoting and disseminating sound management practices. This is particularly the case for the fair pricing of financial services to ensure a competitive playing field that is not detrimental to the sound position of the financial participants.

At the macro-prudential level, it falls to the relevant authorities to ensure macro-financial and macro-prudential oversight.

- Domestic supervisors play a fundamental role in this respect. They have close links to the financial players and have a deeper understanding of developments in their respective sectors. They can monitor such developments in real time and react to them more effectively.
- The internationalisation of activities and of financial institutions also calls for in-depth discussion and close cooperation between national supervisors.

The work conducted by international supervisory organisations, such as the Basel Committee, the IAIS or the IOSCO, makes a vital contribution to this effort. The implementation of the numerous international codes and standards developed by these bodies has now to be carefully examined. Allow me to seize this opportunity to salute the work the Financial Stability Forum is accomplishing in this respect.

The financial authorities' second objective should be to constantly verify the relevance of safety nets.

Regulators must, of course, ensure that their supervisory mechanisms are adapted to an evolving financial sector. The Gramm Leach Bliley Act adopted last year by the United States illustrates this concern, which has resulted in a new allocation of the roles of the different American supervisors.

As regards the European Union, the integration of national financial systems within a large, efficient market is the ultimate objective of the regulatory harmonisation. Since 1977, when the first banking coordination directive was laid down, two key principles have constantly been applied:

- On the one hand, the "European passport" gives the right of establishment and freedom to provide services within the area.
- On the other hand, supervision on a consolidated basis entrusts the consolidated supervision of banking groups to the home country, in cooperation with the host country.

These are the two pillars of our European prudential framework. They are the basis for a clear definition of the respective roles of and close cooperation between national supervisors. Thanks to these principles, prudential supervision within the EU has for many years been conducted in a decentralised and cooperative manner which has proved its worth. In this respect, national supervisors are well prepared for the integration of the different national financial systems.

The same principles broadly apply for the supervision of insurance companies and insurance firms. As for cross-sector pan-European complex institutions, we believe that a similar combination of specialisation and intense cooperation is the best solution.

Lastly, the third objective of financial authorities must be to achieve a new balance between regulations and market discipline

The first generation of prudential rules - chiefly a raft of prudential ratios with the Cooke ratio as its symbol - was devised at the end of the 1980s under the aegis of the Basel Committee, the IOSCO and the IAIS.

As financial activities evolved, these quantitative standards were gradually supplemented with a more qualitative approach based on risk management and market discipline. I would like to emphasise that far from being at odds, these two approaches are complementary and inseparable.

Financial participants must be encouraged to take more responsibility in mutual surveillance in order to encourage market discipline. This means that they must adopt more transparent procedures.

However, regulators and supervisors still have an essential role to play in ensuring the stability of financial systems which is necessary to the common good.

- Maintaining a balance between market discipline and regulations should lead to a more flexible approach whereby prudential standards are adapted to the individual situations of financial institutions. This is the purpose of the revision of the solvency ratio currently underway in Basel, in particular via the second and third pillars.
- In addition, the mechanisms for safeguarding the soundness of financial systems should be adapted to the changing features of these systems. Some of the aspects we feel should be given priority are:
  - how to deal with financial institutions that are not yet regulated, such as financial conglomerates and highly-leveraged institutions, or certain types of financial holding;
  - how to deal with remote financial services.
- Finally, regulators must ensure that the new regulatory mechanisms they have devised fit in with the other objectives of economic policy. The impact of these regulations on the real economy must be carefully assessed in order to avoid privileging stability to the detriment of efficiency by creating new competitive distortions. In general, prudential concerns about financial stability, monetary concerns about price stability and social concerns, that is, protecting consumers, must be reconciled.

In conclusion, allow me to mention the key role played by central banks in reinforcing financial stability

First of all, I would like to stress what I feel is the highly complementary nature of the price stability and financial stability objectives. I believe that price stability is the bedrock on which financial stability is built. It is of course a prerequisite.

Secondly, I consider central banks to bear a special responsibility arising on their central position at the heart of financial systems:

- They contribute directly to supplying liquidity to the economy.
- Their close and constant contacts with credit institutions give them a thorough understanding of banking systems.
- They are responsible for ensuring that payment systems operate smoothly.

Central banks thus find themselves at the intersection of the various aspects of financial systems, and accordingly appear particularly well-suited to maintaining financial stability.

Thirdly, in my opinion, the correct answer to the changes underway in financial systems is not to set up vast centralized supervisory bodies at a global or a European level. In this domaine to be close to the credit and financial institutions concerned is decisive for efficiency. I am convinced that establishing a new generation of prudential standards and reinforcing active and close cooperation between decentralised supervisors will be for us the best means to reconcile efficiency with financial stability. To deal with these challenges, given their specific features, central banks are obviously at the heart of the process.