Jean-Claude Trichet: The European Regulatory and Supervisory Framework – the views of the ECB

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 2008 Eurofi Conference, Nice, 11 September 2008.

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Ladies and Gentlemen,

Introduction

It is a great pleasure to address this extremely distinguished group of European executives and policy makers. Eurofi plays a key role in the ongoing reflections regarding the integration and efficiency in the European financial industry and its yearly conference is always a unique opportunity for lively debates on current financial services issues in Europe.

With the event of today, the organizers aim to provide input from the financial services industry to the priorities and proposals of the European policy makers. On my part, I intend to share with you a few reflections on some implications of the financial market correction for both the private and the public sector.

General issues

Let me start by recalling that the financial market correction – taking the form of a generalized re-pricing of risks and de-leveraging – which was triggered by surging delinquencies on US sub-prime mortgages now more than one year ago, is an-going process. The overall impact so far on the financial system has been considerable. Confronted with such an extent of turbulences, high level of volatility and overshooting, unprecedented in the industrialized financial systems since World War II, both public authorities and the industry have responded swiftly to cope with the new situation and to draw all lessons from the present episode in order to avoid recurrence of such an abrupt and disturbing correction in the future.

Let me recall briefly these responses. At the international level, we agreed on the appropriate methodologies to draw the lessons from the turbulent market correction. The Financial Stability Forum (FSF) – which had been created after the Asian crisis and has proved its efficiency on this occasion – investigated how financial market and institutional financial resilience could be improved and its report of April this year lists 67 recommendations in areas consistent with the ones identified by the ECOFIN Council. The G7 and the international community fully supported the FSF recommendations at its meeting in Washington last April and the FSF is now well engaged in monitoring closely the actual implementation of the recommendations. At the level of the European public sector, the ECOFIN Council endorsed in October 2007 a roadmap defining a list of actions to be completed in the course of 2008. The Council identified four priority areas for action: (i) enhancing transparency; (ii) improving valuation standards; (iii) reinforcing prudential rules and risk management in the financial sector; and (iv) improving market functioning. Very active work is well under way for the actual implementation of the Council's action points.

The private sector for its part has engaged in important initiatives, including in particular the report of the Institute of International Finance (IIF) on market best practices and the report by the Counterparty Risk Management Policy Group (CRMPG) on containing systemic risk.

The outcome of the analyses has highlighted major issues for the banking sector in the present global finance. In this respect, I would like to focus more particularly on three questions. First, the transfer of credit risk, as epitomized by the «originate to distribute

model ». The second is the unprecedented liquidity problems faced by banks. The third relates to the cooperation between central banks and supervisory authorities.

The «originate to distribute» model

Let me first refer to the «originate to distribute» model which has spread diffusely in the financial industry in recent years. As is well known, this business model relies heavily on securitization, notably the origination of loans by banks that are repackaged into tradable securities distributed to investors. Securitization is indeed at the center of the financial disturbances we have witnessed and some would even see the recent events as the beginning of the end of the OTD model; looking at some of the figures one may well believe this. The European Securitization Forum forecasts that securitization issuance volumes in the EU for 2008 will be EUR 272 billion or more than 40% lower than in 2007; for residential mortgage backed-securities the drop is predicted to be 50%. Since August last year some banks are in effect forced to hold a substantial portion of new securitization issuance on their own books.

But just as the strong growth of securitization before the correction led many observers to overemphasize the pros of the OTD model and neglect the cons, the present situation may well create a reverse tendency. Indeed one risks forgetting that over recent years the OTD model delivered numerous benefits to financial markets participants, including an increased ability to hold or transfer credit risk, improved funding possibilities and capital efficiency and more flexibility in reducing credit risk concentration. These are pertinent motives to continue resorting to securitisation so that in my view the OTD concept will remain valid, though certainly not in the same form and to the same extent as in the recent past. It remains important that policy makers are aware of these benefits when considering possible public action.

But it has to be stressed that along with the development of the securitisation market, its complexity, leverage and opacity have significantly increased, which raises serious concerns. The fact that various participants – originators, intermediaries, rating agencies, investors – in the securitisation process have diverse, and often conflicting, incentives plays an important role here.

The fights against the adverse consequences of conflicts of interest should be engaged in the first instance by the market participants themselves. In this respect, transparency is a powerful tool. For instance, transaction documentation relating to securitisation operations should explicitly specify possible conflicts of interest and how they are dealt with. In addition, a more standardised and detailed disclosure related to the underlying portfolios of securitisations would be beneficial for the efficient functioning of the market. I appreciate that in this domain of transparency the industry is making substantial efforts. They have to be actively pursued.

When self-regulation and/or industry initiatives turn out to be insufficient, regulators have to step in, following a thorough assessment of the costs and benefits of introducing new rules. If there is scope for imposing new rules, it is important, given the global nature of the securitisation process, that they are agreed by regulators at the international level.

Another aspect I would underline in this context relates to the issuance of covered bonds. Indeed, the performance of covered bonds proved up to now to be relatively resilient to the financial market correction compared to asset-backed securities. Covered bonds are already the most important privately issued bond segment in Europe’s capital markets with over EUR 2 trillion outstanding at the end of 2007. From a financial stability perspective, they have a number of attractive features, not least the fact that the credit risk stays with the originator, which strengthens the incentives for prudent risk management; generally they are also more transparently accounted for in banks’ published accounts than securitisation transactions.

Banks' liquidity management

This brings me to a second important area highlighted by the financial market correction, namely liquidity management. Indeed, the shaken confidence in the OTD model reflected itself foremost in evaporating market and funding liquidity. As banks were forced to take securitized assets on their balance sheet again and provide funding under committed liquidity lines, they were at the same time confronted with serious and unexpected liquidity drains.

In the light of the experience, it is fair to say that liquidity risk has been neglected in banks' overall risk management compared to all the attention that over the past years has gone to capital management. The events of the past year have been a strong reminder that liquidity risk is a key risk for banks to manage and which even profitable and solvent institutions cannot afford to downplay.

This is also an area where in the first instance it is for the financial institutions themselves to pursue improvements in their liquidity risk management systems. However, there is also room for more coordinated action by the regulatory and supervisory authorities. In fact, over the past months, the Basel Committee on Banking Supervision at the global level and the CEBS at the European level have been working on possible recommendations for improvements in this area which were recently subject to public consultation.

Central banks, as ultimate liquidity providers, have a strong interest in the ways banks manage their liquidity. Therefore, with the assistance of the Banking Supervision Committee, the Eurosystem has investigated in detail how banks manage their liquidity, in particular through the use of liquidity stress tests and contingency funding plans. It is worth recalling a few key findings of this analysis.

A first general finding is that industry practices show a wide diversity as regards the components and details of liquidity stress tests and contingency plans. Clearly, a generally accepted industry standard has not yet emerged and thus all relevant parties are invited to undertake efforts in this direction.

Second, it emerges, not surprisingly, that central bank facilities are an essential part of banks' contingency funding plans. A number of banks indicated that in response to the financial market correction they intend to place more emphasis on such facilities. As a central banker, I wish to be sure that banks can manage their liquidity risk on their own and not rely mechanically on central bank refinancing beyond common lending facilities and open market operations. Emergency liquidity assistance by central banks should therefore not be relied upon by banks in their liquidity planning.

Finally, public authorities should improve their monitoring of the liquidity situation of the financial system and its components by drawing on the liquidity stress tests results of individual banks. This should be achieved by organizing concerted rounds of common liquidity stress tests whereby participating banks would use their own approaches to carry out liquidity stress tests based on a common scenario. In this way supervisors and central banks could approximate the potential systemic impact of the scenario selected. Banks would benefit as well from such an exercise through benchmarking and learning effects.

Cooperation between central banks and supervisors

Let me then turn to the last topic I would like to touch upon, namely the cooperation between central banks and supervisors. I will consider three areas where I see major scope for improvement, namely financial stability assessments, liquidity and crisis management.

The *periodic monitoring and assessment of financial stability* conducted by central banks would benefit from an enhanced cooperation between central banks and supervisors. In that context, I recall that the FSF stressed in its April report the need to improve the interaction between central banks and supervisors in the early detection of risks to the financial system. This entails that the supervision of individual institutions should be enhanced with central

banks' financial stability assessments, which in turn should benefit more from supervisory insights.

I am fully supportive of this recommendation. In their financial stability assessments, central banks take a "top down" approach by focussing on the main macro-prudential risks. Supervisors, by contrast, take typically a «bottom up» approach by looking at the risks of individual institutions. Somewhere these two approaches have to meet and influence each other for the better. For central banks this may mean that they have to communicate their financial stability assessment in a way that is directly relevant for supervisors, while supervisors have to bring to the attention of central banks developments in individual institutions that are important for the financial system as a whole.

This recommendation is clearly relevant not only at the national level but also at a cross-border level. Concerning the EU in particular, this presupposes an effective interaction between the assessment of risks faced by the EU banking sector made by central banks and supervisors, as reflected in the analyses of the BSC and CEBS respectively.

An important aspect of the cooperation between central banks and supervisors in periodically assessing the financial stability conditions is central banks' access to supervisory information. In normal times, the assessment of risks for the financial system as a whole needs to rely on a large set of information sources, including those from banking supervisors. An immediate example is represented by the data on the solvency and profitability of the banking sector, as well as ad hoc information on specific exposures of the banking sector. While it is fair to say that there exists already extensive access by central banks to supervisory information there is certainly room for improvement in terms of timeliness, frequency and detail. Take the example again of the «originate to distribute» model. Once could argue that in case central banks had access to more detailed supervisory information on banks' involvement in securitisation operations they would have found it easier to assess the implications of this development for the financial system as a whole.

When a situation of financial stress actually emerges and risks developing into a financial crisis, supervisory information remains again crucial for central banks' financial stability assessment. But in this case, the need for information will be very much driven by the nature of the stress. In the present market conditions, central banks are of course very much interested in banks' exposures to the US sub-prime sector and to structured financial products, as well as the effect of the price corrections on banks' solvency position.

A second area of cooperation I want to mention is *liquidity*, which is again at the cross-roads of central banking and banking supervision. Much of the work that central banks and supervisors are undertaking to render financial institutions and markets more resilient to liquidity shocks is interrelated and offers therefore scope for mutual cooperation. I will give just one example referring to a topic I mentioned already earlier, namely banks' contingency funding plans. While normally supervisors require banks to set up these plans, central banks should also have access to them as an element to be considered in the context of deciding on liquidity provision.

The final area I would mention is *crisis management.* In this field, the FSF report makes also a number of recommendations that pertain to the cooperation between central banks and supervisors. More specifically, the report recommends that for the largest cross-border financial firms, the most directly involved supervisors and central banks should establish a small group to address specific cross-border crisis management planning issues.

I believe that in Europe, the right principles have been agreed to meet this recommendation. The Memorandum of Understanding (MoU) on cooperation on cross-border financial stability includes appropriate provisions on the cooperation between central banks and banking supervisors, for example when assessing the potential systemic implications of a financial crisis or when emergency liquidity assistance will be provided to a cross-border financial group. A second important reinforcement will come from the scheduled changes to the Capital Requirements Directive, which include several aspects relating to the cooperation

and exchange of information between central banks and banking supervisory authorities also in crisis situations.

Concluding remarks

Ladies and gentlemen, let me conclude. The financial market correction has revealed areas in the regulatory and supervisory framework which need to be promptly addressed by public authorities and the financial industry. In the EU, the ECOFIN roadmap of October 2007 is in that respect the benchmark and it is important that the actions identified are indeed fully implemented without delay.

I think it is equally important that continued efforts are put into the realization of two other ECOFIN roadmaps, namely the one regarding strengthening the EU arrangements for financial stability and the other one on enhancing the Lamfalussy framework. Both are indeed highly relevant in the context of the financial market correction.

A major step in strengthening the financial stability arrangements was taken with the signature of the MoU on cross-border financial stability. The next step consists of implementing and testing the memorandum's procedures and principles, in which the ECB is actively involved. A second important strand of work under the heading of enhanced financial stability arrangement consists of reviewing the policy tools for crisis prevention, management and resolution at the EU level, where the European Commission takes the leading role.

The market correction has underscored the urgency and importance of enhancing cross-border convergence and cooperation in the supervision of cross-border banks in the EU, which is the objective of the roadmap on enhancing the Lamfalussy framework. Only in this way the necessary preconditions are in place to ensure an effective monitoring of, and response to, cross-border financial risks by banking supervisors. To that end, it is important to ensure that the Level 3 committees as well as the colleges of supervisors can work as effectively as possible.

Ladies and gentlemen, John F. Kennedy once famously said in a speech that the Chinese word for crisis is composed of two characters, one representing danger and the other opportunity. Although I still prefer to speak of financial market correction, I believe I showed you that both elements are indeed present today.

I thank you for your attention.