Mario Draghi: How to restore financial stability

Lecture by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Forum, at the 5th Bundesbank Lecture, Berlin-Brandenburgische Akademie der Wissenschaften, Berlin, 16 September 2008.

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As this crisis hits its first anniversary, it has evolved into an even more complex combination of rising inflation, declining growth, tightening credit conditions, and widespread liquidity tensions pervading the global financial industry. Banks have raised a significant amount of capital to partly offset writedowns and credit losses. But they are now moving into a phase where credit losses in the banking book will begin to rise. And banks are entering this phase with weakened balance sheets. Alongside a rise in credit related losses, the outlook for bank profitability is poor.

The aggregate amount of capital in the system is great enough, under reasonable scenarios, to prevent the system as a whole from falling below regulatory thresholds. But the distribution of that capital obviously matters. And, for larger banks, the capital levels demanded by the market have gone up in response to the greater uncertainty and reduced transparency about their balance sheets.

We estimate that banks are likely to need to raise at least once again the amount of capital raised since the crisis began. There are various reasons why some banks will be struggling to reach those levels. That is especially the case for the banks that ran the debt-financed, highly leveraged and maturity mismatched business model that provided steady fee income over the last several years. Now their profitability looks impaired, and their desired de-leveraging is likely to be happening through a reduction of new lending. Capital increases are especially difficult in a situation of deteriorating stock markets where falling equity prices nullify the still significant efforts undertaken to delever banks' balance sheets. This has spurred increasing recourse to hybrid capital instruments, but these may raise in the future concerns about the quality of the capital raised. Let me finally observe that the situation of the banks in the Euro area is so far better than the one we are witnessing in the US and in other jurisdictions.

As the crisis unfolds policies are taking a variety of shapes that can be grouped within two broad categories: emergency and structural responses. Until now, the first remained typically national since each crisis was unique to the financial structure of the country and so were the remedies. However, if the crisis were to become systemic – and the past weekend has shown just how sudden and dramatic the turn of events can be – I believe that an internationally coordinated effort will be necessary.

On the other hand, it was immediately clear that the structural response that would lay out the foundations for a more resilient financial system in the years to come could not be other than internationally coordinated. It is primarily to this effort that the Financial Stability Forum (FSF) has been called to respond by the G7. The FSF – brought into being by Hans Tietmeyer in 1999 – brings together national financial authorities (central banks, supervisory agencies, and finance ministers) from large international financial centres as well as bodies such as standard setters and international financial institutions, giving it a unique capacity to give impetus to and facilitate coordination among these bodies.

Our conviction is that misaligned incentives in several areas of the financial services industry weakened lending and underwriting standards, particularly but not exclusively in the United States. At a more general level, innovation and complexity outstripped banks' capacity to manage key risks – including funding and liquidity risks, concentration risks, reputational risks, legal risks and warehousing risks. Investor due diligence was poor and reliance on credit ratings unquestioning. Institutions accumulated a level of leverage that was both

misperceived and excessive. The initial spark set off by the U.S. subprime downturn fed on these much broader weaknesses, causing the dramatic loss in confidence and liquidity in financial markets that we have seen. This explains why initial losses that might have been insignificant are having such meaningful consequences on the real economy in both Europe and the U.S.

The financial system that will emerge from this crisis will be one that operates with less debt and more capital, should be immune to the set of perverse incentives that are at the root of the crisis, and should be such that the risks are better assessed and identified. In the end, while avoiding over-regulation that would stifle innovation, the reform process will re-draw the balance between market discipline and regulation.

The FSF report, which was endorsed by the G7 ministers and central bank governors in April this year and has been made public, draws on an extensive body of work by national authorities and the main international supervisory, regulatory, and central bank bodies. A key strength of this report is that it contains recommendations that have been agreed by those that have the authority and commitment to implement. Another key strength is that it aims at correcting the identified weaknesses while preserving a level playing field across countries. A well-defined process is in place for following up on implementation, comprising who does what and by when, and how progress is to be monitored and reported. A comprehensive follow-up report will be presented to the G7 next month.

Our recommendations were in the following key areas:

- Strengthening the prudential framework for banks, including with regard to capital, liquidity, risk management and market infrastructure;
- Strengthening the framework for transparency and valuation;
- Changing the role and uses of credit ratings; and
- Enhancing the authorities' responsiveness to risks and our co-operation in dealing with weak banks.

Progress in taking forward implementation of these recommendations has been remarkable. To name a few examples:

- Supervisors proposed in July new capital requirements for credit exposures in banks' and securities firms' trading books and will set out later this year adjustments to capital requirements for "re-securitisations" and the short-term liquidity facilities that funded off-balance sheet conduits.
- In May, the Basel Committee issued revised guidance on liquidity risk management that materially raises standards for sound liquidity risk management and measurement – including requiring banks to maintain a robust cushion of unencumbered, high quality liquid assets as a safeguard against protracted periods of liquidity stress.
- Over summer, IOSCO and the SEC set out fundamental changes to their requirements on credit rating agencies to address the quality of ratings, to expand the information they provide, as well as proposals concerning how ratings are used in regulatory guidelines.
- Regarding transparency, the larger banks have implemented our recommended disclosures to provide expanded information on their risk exposures and valuations of problem assets, on and off the balance sheet.
- And the IASB is making good progress on new guidance and revised standards for fair valuations when markets are illiquid, and for consolidation of off-balance sheet entities, which we expect to see in the next few months.

On the private sector front we welcome the recommendations that have been set out by the Institute of International Finance (the IIF), the Counterparty Risk Management Policy Group III, and the American and European Securitization Forums. The industry's involvement in drawing lessons from events has heightened the understanding of market participants of the need to redraw the balance between unfettered markets and regulation.

Some of the regulatory changes that I have discussed will need to be phased in over time to avoid adding to the adjustment challenges the system faces now. However, there should be no uncertainty about the authorities' determination to implement the program of actions that has been internationally agreed. And there should be no stretching of timetables for enhancing disclosures, including of off-balance sheet positions, as this is essential to repairing market confidence.

No financial system will be free from crisis whatever the rules of the game. The fundamental task for authorities is therefore to enhance the resilience of the financial system to shocks and disruptions whatever their source, with a view to minimising the knock-on effects elsewhere.

At the level of the financial system as a whole, a critical element is the infrastructure of payment and settlement systems, and the body of contract documentation and market practices that underpin financial activity. A resilient infrastructure is one that is capable of withstanding the effects of the failure of a large financial institution. As we speak this objective is being tested by reality. By reducing the centrality of any one institution to the system's stability, a stronger infrastructure also contributes to reducing moral hazard. A critical priority in this area is to address weaknesses in the operational infrastructure of over-the-counter derivatives markets. The work undertaken by the NY Fed to this end should be commended by all the jurisdictions. The objective of this work is to move the OTC derivatives markets on to a platform where trades can be captured and settled in an orderly way.

It is also imperative that we strengthen national and cross-border crisis resolution frameworks so that we can allow weakened financial institutions, including large ones that operate across borders, to be wound down in an orderly manner. This is an area where the mismatch between what we need to have in place, and what is in place, is large. In addition to important national reform efforts in a number of countries, work is underway in the FSF and the Basel Committee to strengthen cross-border cooperation and contingency planning among authorities in responding to crisis.

At the level of individual institutions, improving resilience means ensuring that capital and liquidity buffers are large enough to enable firms to resist external shocks – without mandating buffers at a level that impedes efficiency and encourages regulatory arbitrage. The issue is quite complex because both the actual and the appropriate size of a buffer shifts over time depending on the market and systemic environment. Both the markets and regulatory authorities affect the level of capital and liquidity buffers institutions maintain.

A key issue, which is particularly relevant in the current period of adjustment, is the ability of banks to use capital levels above the regulatory minimum during adverse conditions. What we have seen is that higher cushions above the regulatory minimum become a new de facto market requirement. Indeed, banks' efforts to raise new capital in the past year have been not just to meet regulatory minima but also to respond to the need to reassure markets. This is, at least in part, because of festering uncertainty over risk exposures, valuations and earnings prospects. Some of this uncertainty is inevitable – for example, terminal values for securities backed by US housing loans cannot be determined as long as the US market continues to fall. But it is clear that we need a much more robust ex ante framework of transparency to reduce the tendency that market reaction lead banks to raise capital (or reduce exposures) to possibly inefficient levels in a systemic crisis. If banks can credibly assure markets that risks to their asset values and earnings prospects are being soundly managed and contained, then they may be able to survive a temporary decline in capital levels when needed, while still remaining above their regulatory minimum.

As the above illustrates, the recent turmoil has raised fundamental questions about the nature of procyclicality, its impact on financial stability, and the feasibility of policies to address it. This brings me to two areas that I believe merit further attention on the part of policymakers going forward:

- First, is there a role for the official sector to address procyclicality as a source of financial instability?
- And second, should monetary policy embody in its objective function the health of the financial system?

Reviewing our experience of the past two or three decades, one is struck by the repeated tendency of financial systems to build up risk and leverage in good times, then shed it rapidly when conditions change. While the assets and agents involved and the triggering mechanisms differ from one cycle to the next, the cycles have tended to produce significant deadweight costs and distortions in the real economy, both during the upswing and during the subsequent retrenchment. This is especially significant the more the financial system is leveraged, as we have seen in the past year. While we cannot and would not want to eliminate the bouts of optimism and pessimism that are part of human nature, we must address some of the pro-cyclical implications of our own policy making.

We decided not to address procyclicality per se in our April report (although some of the recommendations touch on it) because of the urgency of making concrete recommendations in other areas. But now it is time for us to return to this topic. As in the areas that I described earlier, the goal will be to strengthen the resilience of the system without hindering the process of market discipline and innovation that are essential to the financial sector's contribution to economic growth.

There is no shortage of ideas around for which aspect of procyclicality is most relevant for financial stability, and for the range of policy options that could help dampen procyclicality. Some of the areas that we in the FSF have decided to look at include:

- The *capital* regime: the Basel II framework ties required capital more directly to the perceived riskiness of an asset, which is likely to increase during downturns and fall during expansions. This is not new, but because Basel II itself is new there is more we need to know on the mechanics – it is not clear yet, in particular, how required, desired and actual capital levels will evolve over a full cycle under Basel II (although a framework is now in place for tracking and assessing this). As we consider *how* to strengthen the regime, more thought needs to be given to how to promote higher buffers above the regulatory minimum in good times, which can then be dipped into more flexibly during cyclical downturns. To a degree, this is already possible in a discretionary way, although too much divergence in national implementation of Basel II would raise issues of transparency and consistency in international regulatory arrangements and should therefore be constrained. Ad hoc, uncoordinated reductions in required minima could be viewed as forbearance and could give the wrong signal about authorities' judgement as to the overall strength of the system. How we can best dampen procyclicality in bank capital is an inquiry we are now engaging internationally and in the European context in a coordinated fashion.
- A related issue is sound loan-loss *provisioning*: these are useful tools to counter the effects of procyclicality, especially on new lending. However, our banking systems came into this crisis with historically low levels of provisions. To a degree, this can be attributed to the benign recent default environment. But it also reflects new accounting principles and prudential rules, the effects of which we need to assess in the light of experience. Our aim must be to create scope to promote more through-the-cycle provisioning techniques that place institutions in a position to absorb losses rather than curtail credit during a downturn.

- *Compensation* issues – these have been much in the public eye recently: do bonus-based pay systems, for both traders and senior and top management of financial firms, reward short-term risk taking with little penalty for the longer-term risks taken to achieve profits? What are the elements of a sound compensation scheme? On this issue, the interests of regulators and shareholders broadly align but banks face a collective action problem. If there is a role for regulators and supervisors in this area, is it ex ante (to adjust risk taking incentives), and/or ex post (to adjust capital to the risks taken)?
- *Valuation and leverage*: the interplay between these has become more important over time for a number of reasons, including more marketable assets (especially credit) that need to be marked to market, more market-based collateralized funding, more leveraged position-taking. But here too there is more we need to know about the mechanics involved. What effects have valuation practices and leverage had on the cyclicality of the financial system? Acting through which channels? Is there a possible or desirable course of action for the official sector?

Coming to the issue of monetary policy and financial stability – If the market turbulence tells us anything, it is that the pace of financial innovation in recent years, the volume of transaction in certain markets, the amount of embedded leverage in the system, and the global nature of finance, have transformed the functioning of the international financial system. These transformations were not fully appreciated in their implications for monetary policy making.

Central banks are inherently concerned with the health of the financial system. Because of the critical role it performs – that of allocating capital and risk to the economy – a well-functioning financial sector is key for the achievement of primary macroeconomic objectives, such as stable prices and sustained growth; for central banks, it is also fundamental for the effective transmission of monetary policy decisions to the real economy. Contributing to the health of the financial system is, in a sense, encoded in the genes of central banks: one of the historical reasons for establishing a central bank was indeed to reinforce financial stability by having an institution that could act as a lender of last resort.

The policy followed by the European Central Bank since the start of the turmoil is very much in line with this historical role. The ECB has not remained passive. It has used the tools at his disposal, in particular its liquidity operations, to support the smooth functioning of the money market in periods of acute stress. Its operational framework has proved to be robust and flexible to effectively respond to the challenge posed by the drying-up of market liquidity.

However – and this is a crucial aspect of the ECB policy – we have operated under the principle of strict separation between the liquidity provision policy and the stance of monetary policy. Monetary policy, the setting of the level of interest rates by the ECB, has been directed at fulfilling its primary goal: maintaining price stability. This principle is crucial. Charging monetary policy with additional objectives, such as a direct responsibility for financial stability, would risk blurring responsibilities, increasing moral hazard and creating a trade-off where there is none. I fully agree with the remark often made by Otmar Issing that there is no lasting trade-off between price stability and financial stability.[1] Even if, as he acknowledges, some short-term conflicts may occasionally arise, this can be easily accommodated by a monetary policy strategy that focuses on an appropriate medium term horizon, as the one chosen by the ECB. Over such horizons, price stability and financial stability are mutually reinforcing, rather than alternative, goals. We should not forget that some of the most damaging and prolonged periods of financial distress (such as the Great Depression, the Japanese experience in the 90's and many of the currency crises in

[1] O. Issing (2003), "Monetary and financial stability: is there a trade-off?" BIS paper No. 18.

emerging markets in the past century) have been associated with – and sometimes aggravated by – the inability to control the inflation process.

Relying on a clear separation of roles and a correct assignment of instruments to objectives is particularly important at the current juncture, as we face inflationary pressures combined with weaker economic activity and financial turbulence. It is precisely in these difficult situations that the benefits of a sound monetary framework become apparent. Only by ensuring a return to price stability in a reasonable time frame we will be able to control inflation expectations, reduce uncertainty and risk premia, sustain longer-term financing and purchasing power and thus reinforce the prospects for real activity and financial stability. The risk that a prolonged period of high inflation may destabilize expectations and become entrenched in wage and price setting requires a resolute stance in monetary policy. It is essential that other economic actors too adopt a responsible behaviour. It is also quite obvious that should current financial instability aggravate and threaten to lead to a deflationary situation, monetary policy would have to take this into account.

While the role of monetary policy in the current circumstances should be clear, it is nevertheless wise, also in this field, to draw lessons from the recent experience. An important one, which relates to the topic of procyclicality I just mentioned, is on the role that unusually easy global credit conditions over many years had in the build up of the current turmoil.

There is a clear asymmetry between the two phases of boom-bust cycles. While the effects of the bust phase are very visible, the building-up of imbalances in the boom phase is not easily detected. This is because there are of course many other factors – not necessarily related to imbalances – that contribute to changes in asset prices and balance sheet positions, and not all booms end up in busts. Central banks are thus easily forced into a situation where they may need to intervene after the crash, injecting liquidity to avoid a financial crisis, or even at times loosening monetary policy to avoid deflation, but remain passive during the previous phase. The problem however is that a monetary policy that limits itself to such a passive role – the so called "mop up after" policy – may increase moral hazard and plant the seeds for further and more acute imbalances in the future.

The key challenge is therefore to understand whether monetary policy can or should be more proactive and "lean against the wind" also in periods of growing financial imbalances in a pre-emptive manner, even in the absence of immediate threats to price stability. This is an open issue on which opinions diverge. I will limit myself to the following observations.

First, risk premia in equity, housing, government bonds and corporate debt markets had reached over the past ten years – with different timing – a historical minimum. They had consistently declined since the mid-eighties. There are structural reasons behind this trend: the deepening and broadening of global financial markets; and more stable policy regimes, in particular for monetary policy, leading to lower macroeconomic volatility – and therefore risk – in the last two decades (a phenomenon also known as the Great Moderation).[2] But there have also been transient, and thus less comforting, factors at work: lower volatility in the economy may have been due to "good luck", i.e. a historically unprecedented decline in the vigour of exogenous shocks. This may have generated a false perception of safety. Most importantly from the point of view of monetary authorities, protracted low interest rates at the global level may have favoured an excessive appetite for risk, reinforcing the flawed incentives in risk management that have played a pivotal role in the recent turmoil. Indeed, the existence of a "risk taking" channel – an impact of monetary policy on either risk perception or risk tolerance – appears to have some ground in both theoretical arguments

[2] A detailed exposition of this topic can be found in J.-C. Trichet (2008), "Risk and the macro-economy" keynote address at the conference "The ECB and its watchers X", Frankfurt am Main, September.

and empirical research.[3] Again, all this is not new. From a historical perspective, accomodative monetary policy has been found to be a key factor in many cycles that ended up in crises.[4] The underestimation of risk is particularly worrying when it involves the housing markets, as participants are likely to be on average less informed and less protected against changing conditions than is the case in other markets. Protracted low interest rates associated with asset price booms – especially in housing – very low risk premia and buoyant credit growth should ring a bell to policy makers.

Second, the thorough analysis of intermediaries' balance sheets and monetary and credit developments, which the Bundesbank has championed and is now an essential part of the ECB strategy, is crucial in this field. Besides supporting the assessment on the outlook for price stability, this analysis could be an indispensable ingredient of a monetary policy aiming at a higher symmetry of response to boom-bust cycles, reducing procyclicality and moral hazard in the financial sector. Monetary analysis may be all the more important in situations of potential financial distress when it is necessary to lengthen the horizon of policy, but it is very hard to do so by means of forecasts given the complexities involved. This may be even more true if we allow for the possibility put forward by some observers, that when monetary policy is highly credible, excessive liquidity expansions may find their way first in fuelling asset price and credit booms, rather than in creating inflationary pressures.[5] The analysis of credit and money has also permitted us to form a balanced opinion on the effects the financial turmoil. While we do see a slowdown in credit growth in the euro area, this appears to be in line with the regular impact of slower economic activity and tighter policy conditions. Up to now, we have seen no signs of additional effects coming from financial tensions, and so far the capital position of banks overall in the euro area remains sound. Of course, if the crisis were to become systemic, counterparty risks could always spread all over the world.

Third, I do not think that central banks possess a superior knowledge, relative to the private sector, to be able to judge whether a deviation from fundamentals is occurring in the pricing of any individual asset. Having said that, central banks – with their strong technical skills, independent judgement and system-wide, longer-term perspective – are perhaps better placed to assess systemic risks emerging from financial markets. This can prompt informed communication to the financial system and to the wider public and, at times, also monetary policy action. As it is the case in general when confronting low-probability but high-cost events, it may be optimal to choose to err on the side of caution if this helps to reduce the likelihood of future crises.[6]

Fourth, as recently recognized by Adrian and Shin among others, in a market based financial system, banking and capital developments have become inseparable.[7] Through the impact it has on capital market conditions, monetary policy may have become more important in influencing the size of financial intermediary balance sheets. In this respect it could play an important role in dampening fluctuations that may lead to potential disorderly unwinding of

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[3] See, among others, G. Jimenez, S. Ongena, J.L. Peydrò, and J. Saurina (2008), "Hazardous times for monetary policy: what twenty-three million bank loans say about the effects of monetary policy on credit risk-taking?", CEPR discussion paper No. 6514.

[4] C. W. Calomiris (2008), "The subprime turmoil: what's old, what's new, and what's next", paper presented at Federal Reserve Bank of Kansas City's symposium, Jackson Hole, August 2008; Bordo, M. (2007), "The crisis of 2007: the same old story, only the players have changed", paper presented at the Federal Reserve Bank of Chicago and International Monetary Fund conference "Globalization and systemic risk"; Chicago.

[5] Borio, C. and P. Lowe (2002), Asset prices, financial and monetary stability: exploring the nexus", BIS working papers, No. 114.

[6] Bordo, M. and O. Jeanne (2002), "Monetary policy and asset prices: does "benign neglect" make sense?" International Finance, 5(2).

[7] Adrian, T. and H. S. Shin (2008), "Financial intermediaries, financial stability and monetary policy", paper presented at Federal Reserve Bank of Kansas City's symposium, Jackson Hole, August 2008.

leverage. Given the interlinkages existing in the global system, today this is true not only in the Anglo-Saxon systems, but also in the more bank-oriented European context.

Therefore, while monetary policy should continue to focus on delivering price stability, it should aim at a greater symmetry throughout the cycle and cannot afford to neglect the modifications and innovations affecting the structure of the financial system.

We should not, however, underestimate the enormous informational challenge we have to confront. We need to improve our analyses and tools to be able to better assess the risks of a systemic crisis, quantify the effects that our actions may have to mitigate those risks and develop a deeper understanding of the two-way linkages between the financial and real sectors. In this respect, a closer interaction between macroeconomic and macroprudential analyses is essential. This requires stronger cooperation and information sharing among authorities both domestically and cross-border. Moreover, greater transparency and improved disclosure practices in the private sector are necessary to be able to fully assess the conditions of the financial system and formulate the appropriate monetary policy. In this sense, monetary policy and policies to achieve financial stability are closely linked.

The crisis we are facing is one of the most severe and complex of our times. The challenges will be substantial: restore price stability that would support growth, and ensure that the needed adjustments in bank and households balance sheets and in internal and external macroeconomic imbalances take place in an orderly manner. This will require action on the monetary, fiscal, and regulatory front. It will also require decisive action by the private sector to repair balance sheets, strengthen corporate governance, and improve the functioning of markets.

History has repeatedly shown that needed reforms are ignored until a crisis forces action, and that the will to reform quickly dissipates after the crisis has passed. This crisis is no different, and this is an opportunity to strengthen the structure of the financial services industry.