Yves Mersch: Financial stability – quo vadis?

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the Seminar on Financial Stability, Central Bank of the Republic of Turkey, Ankara, 21 October 2008.

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Let me start by thanking the Central Bank of Turkey for having provided the opportunity to present my views on financial stability, likely the most discussed policy issue these days. I shall not dwell on the description of where financial markets and economies stand today as this is well known by this audience. Instead, I shall discuss the evolution of financial stability frameworks in general – and in the EU in particular – and, profiting from the ongoing financial markets crisis, I shall draw lessons that could guide us in enhancing the EU framework of financial stability. *Noblesse oblige*, I will stress the crucial role played by central banks in that endeavor given the accrued importance of liquidity in preserving financial stability in the modern world of structured finance. The bottom line is that we will have to go well beyond implementing changes in accounting rules, in the modus operandi of rating agencies and in the risk management procedures of financial institutions.

This is hardly a time to herald the joy of central banking! At the time of writing, news of financial instability and ample central bank-coordinated increases in liquidity fill up our screens. Lehman Brothers Holdings filed for Chapter 11 bankruptcy protection a seminal event in the intensification and broadening of financial turmoil. Bank of America purchased Merrill Lynch for $50bn; in an unprecedented action, the Fed agreed to provide an $85bn loan to AIG in exchange for an 80 percent stake in the troubled insurer; Fortis was bailed out, with the Benelux governments agreeing to inject €11.2bn and taking a 49 percent stake in the group as a result; the U.K. government took over Bradford & Bingley, nationalizing its loan book and selling its branches and savings operations to Spain’s Santander; Iceland’s financial system collapsed; Belgian bank Dexia received a €6.4bn capital injection from Belgian, French and Luxembourgish governments. Huge public sector interventions were set in motion in the United Kingdom, France, Germany, Ireland, Denmark, Austria and Switzerland among others either in form of guaranties, recapitalizations or distressed assets relief. In the U.S., the Treasury obtained Congressional approval for sweeping powers to purchase $700bn worth of illiquid U.S. mortgage-related assets created prior to September 17, 2008. In addition, a $50bn U.S. state guarantee became necessary to stop institutional investors withdrawing funds from U.S. money markets funds. Hedge funds and money market funds are facing intense redemption pressures and several emerging markets are experiencing financial difficulties and calls for IMF support are suddenly back on the agenda. Interest rates have been further cut in several countries and deposit guarantees increased. *In fine*, leaders from 15 nations committed to a coordinated effort to bolster financial systems with rescue packages totaling nearly 1.9tn euros and central banks offered unlimited dollar funding to banks in short-and medium-term maturities at fixed rates and longer maturities.

Financial stability and liquidity, and the evolution of the supervision paradigm

It is noteworthy that there is neither a widely agreed definition of financial stability nor of liquidity. Definitions of financial stability and liquidity vary significantly in academic papers and among policy makers. Definitions are more than amusing conceptual constructs; they are useful tools to discuss the evolution of financial frameworks and the role of central banks in financial stability. I suggest as definition of financial stability a dynamic one: I view financial stability as a range of states in which the financial system facilitates the performance of the monetary economy, and is able to dissipate financial imbalances originated either endogenously or as a result of adverse unanticipated events. The key elements of the definition are that financial stability is best viewed as a *process* and as such, it is *uncertain*, it has intertemporal and evolutionary features. In addition, this process occurs in a *monetary* *economy*, one based on *fiat* money, where resources and risks are mobilized efficiently. Finally, the process has *self-equilibrating mechanisms* that preclude that arising imbalances trigger a crisis.

"Liquidity is an elusive concept". That is the first sentence of the Banque de France's February 2008 Financial Stability Review. As with financial stability, I suggest as working definition of liquidity a dynamic one: I view liquidity as the ability of market participants to *take risks* on each other as they seek to fund asset purchases and meet obligations, both over normal and stressful environments. As it was the case with the definition of financial stability, this definition of liquidity stresses its dynamic aspects. The *endogeneity* of liquidity indicates that it is best viewed as the outcome of confidence among market participants on the risk distribution of the decisions they make, and thus the monetary price they pay or receive. Liquidity is not an intrinsic, static, feature of financial instruments or markets. This definition of liquidity is compatible with the evidence that modern financial markets may be subject to instability due to liquidity rapidly drying up in interbank markets. One should also disentangle concepts like systemic liquidity, market liquidity and instrument liquidity.

Liquidity and financial stability are therefore intimately linked in a monetary economy. When central banks were created, partly to protect the economy from recurrent episodes of financial instability, their monopoly power to issue the generally accepted means of settlement and their role as bankers' bank made of them the natural guarantors of financial stability. Central banks in Europe, in contrast to the Fed in the U.S., were not explicitly mandated to regulate and supervise financial markets; this was viewed as part of their role in preserving financial stability.

Over time, technological events and the interplay of ideas and experiences modified the role of central banks in financial stability. The Great Depression brought, like major crises normally do, a shift toward increased regulation and the introduction in the U.S. of deposit insurance. In the 1970s, pushed by developments in academia and the limitations of the functioning of deposit insurance, the pendulum turned back toward a more market friendly regulation. Administrative restrictions on banking were increasingly replaced by prudential standards. The main issue at stake was the inherent vulnerability of banks as transformers of short-term liabilities into long-term illiquid assets, and the moral hazard that resulted from the safety net put in place to preserve financial stability via deposit insurance and the lender of last resort. With the advent of big conglomerates and the interrelationships between banking and insurance, growing concerns about the concentration of supervisory powers and monetary policy responsibilities started a trend toward removing supervision from central banks' responsibilities.

The trend toward the elimination of supervision from central banks' role was naturally accompanied by a trend toward integrated supervision.[1] The development of conglomerates blurred the distinction between financial institutions and markets. In addition, the liberalization of capital flows fostered mergers and acquisitions and the appearance of large and complex financial institutions. The experience with the Latin American crisis, and closer to home, with the Finish and Swedish crises, stressed the importance of enhancing risk diversification. Structured finance became the response to that need as it allowed financial institutions to transfer and diversify risk. By pooling together assets such as loans, mortgages or commercial paper, techniques such as securitization made it possible to transfer risk, and separate the underlying assets from the original seller. In addition, central banks' core competence became more structured via monetary policy frameworks with an explicit mandate for price stability and a high degree of technical independence. Central banks' involvement in financial stability was justified by the need to preserve the well

[1] A fully integrated supervisory agency is responsible for the supervision of banking, insurance, and securities markets (e.g., Germany). In contrast, a partially integrated one is responsible for at least two of those markets (e.g., Luxembourg).

functioning of the clearing and settlement payment systems as well as by their role as ultimate providers of emergency liquidity and participation in crisis management.

Financial innovation has brought new vulnerabilities and is forcing again a change in the financial stability paradigm toward a greater involvement of central banks. The reversal of Glass-Steagall in 1999 set off a leverage race outside the banking system, largely unregulated. As capital markets developed in depth and scope, structured complex products further blurred the distinction between banks, insurance and security firms. Property and risk were transferred from the banks' balance sheets to investors, while insurers provided liquidity lines linking thereby, in an inextricable manner, banks, insurance firms and non-bank financial institutions. The expansion of banks' funding sources beyond deposits came, however, at the expense of a more complex assessment of risks. And the spreading of risk expanded the possible sources of instability in ways not always transparent. As a result, the sources of financial instability changed once more: financial instability could also result from market instability (the recent suspensions of short-selling in several countries acknowledge it), from non-bank financial institutions and from ever larger, private clearing and settlement systems. Moreover, liquidity itself could become a contagion channel by triggering discreet changes in asset prices, in the capital base of financial institutions, and thus by feedback onto banks' funding capacity. As a result, interbank markets have now become a source of crisis, or even aggravate a crisis, as fundamental uncertainty makes it too costly for banks to assess counterparty risk. This eventuality, observed in the current crisis, constitutes a clear example of the endogeneity of liquidity.[2] As the role of liquidity and contagion has become more important, central banks' special role in financial stability has been reinforced. Regarding financial institutions, their next generation models of risk management will have to incorporate the non-linearities and discontinuities of modern financial markets.

We may have already moved toward some form of a new international monetary framework. To conclude this section, I remark that the wide range of coordinated responses to the crisis that we are witnessing, a characteristic feature of which has been the predominant role played by central banks, has perhaps sawn the seeds of a global monetary framework. I think of massive recapitalizations of systemically-large institutions and cross-border financial firms and the boosting of deposit insurance limits. At monetary policy level we have witnessed not only concerted action in lowering the policy rate but also narrowing the policy corridor and through asset swaps, provision of cross-border liquidity in US$ and € in unlimited amounts as well as a lengthening of the term funding. This coordination has been accompanied by the enlargement of counterparties either directly or indirectly and we have also seen a broadening of eligible collateral. This new emerging monetary policy framework adjusted in emergency times was required by large cross-border and globalized financial institutions and products. The more flexible and diversified framework of the ECB has, in this respect, proven its benchmark capacity in times of duress even if itself has been enhanced since. The world has moved toward a much more significant coordinated role of central banks in preserving world financial stability. After the times of duress we are living, it is likely that this *de facto* framework might evolve toward a more institutionalized set with some ingredients of a world system of information sharing, with world collateral and world monetary policy.

From a system of national regulators and supervisors to an EU stability framework

Financial stability frameworks in the EU are largely national. Each country's supervisory authorities drive their legitimacy from national parliaments, are subject to national accountability mechanisms, and are financed nationally. Each country's authority is

[2] These features of crises were already present in the case of Continental Illinois (1984), and more recently in the Barings' crisis (1995) and LTCM collapse (1998).

responsible for the consolidated supervision of financial institutions domiciled in that country for which it is the home supervisor. Host supervisors are responsible for subsidiaries of institutions from other countries operating in their territories. National authorities are organized differently in the EU, e.g., as a single authority, or according to a sectoral model. Their mandates also differ with some including financial stability, the protection of investors and creditors, or depositors. Additional tasks such as responsibility over market conduct, consumer protection and market competition are unified to a larger or smaller extent. Each national central bank is responsible for ELA to financial institutions domiciled in its territory with the obligation of informing the ECB. Beyond national banks, the ECB also manages the overall liquidity of the euro area according to market needs. But the ECB does not have direct supervisory authority, and many central banks have few prudential supervisory responsibilities.

An EU umbrella superstructure seeks to facilitate cooperation across national stability frameworks. Many MOUs have been signed to obtain a regular exchange of information and cooperation, and some MOUs have been signed to deal with banks of regional systemic importance. Colleges of supervisors are responsible for monitoring insurance groups and some banks. Lamfalussy committees have been established to promote financial integration and make proposals for the coordination of regulation and supervision in the EU. Level 3 committees, for instance, develop guidelines for the functioning of supervisory colleges and the assessment of financial sector vulnerabilities that are reported to the Financial Stability Table of ECOFIN. EU regulations are applicable to all EU countries (e.g., CRD, MiFID, and Solvency II), but countries can choose the form and methods to implement those regulations nationally. Sometimes national options are numerous: in the CRD more than 100 options were exercised! The EU Commission has enforcement powers in matters related to the completion of the common market, and thus on mergers and acquisitions of financial institutions and injections of state capital. Finally, international organizations and international standard setters such as the BIS, the IMF, the FSF, IAIS and IOSCO also affect EU legislation.

The current EU financial stability framework is a rational outcome of a long evolution, but the current financial crisis, by highlighting its limits, suggests a rethinking is timely. The attribution of responsibilities at the lowest level that can effectively meet them, the *principle of subsidiarity*, has served the EU well. Yet, it is a principle, and as such it requires that the EU financial stability framework that it has delivered so far evolves in tandem with financial innovation. But proximity of supervision is also reflecting the fragmentation of the banking landscape with more than 7.000 banks and only 40 large cross border banks. The EU financial stability framework should ideally deal with the full spectrum of risks, including cross-border risks, at a minimum cost to the taxpayer who remains national. This requires rapid decision-making and quick implementation of remedial actions. Outside observers assert that the operation of large committees and reliance on consensus may slow decision-making while financial innovation keeps accelerating; disparate current national practices hinder integration and competition, as well as increase the regulatory burden; the complexity of regulations and arrangements risks favoring national interests and limiting the exchange of information among supervisors. As the current crisis shows, the outside observer's view might however be clouded by his prejudice.

At political level, decision making in Europe was nimble and decisive at all levels – Eurogroup, ECOFIN, Euro area Summit, European Union Summit, European Commission and European Parliament – within a short time frame. They delivered a more powerful and clearer message in shorter time than other constituencies.

The same goes for the monetary policy level. The decentralized operational modus operandi of the Eurosystem was no hinderness to swift adjustment. During the last month, the Governing Council had 13 non physical decision-making gatherings, outside its 2 physical meetings in Frankfurt, in order to take several dozens of decisions, all implemented since. Overcentralization is no panacea for optimal decision-making as it might hamper collegial wisdom and creative thinking. Each EU Member State has to be concerned by the soundness of financial institutions in other Member States. In this respect, the decision to include a European mandate for national supervisors *could* increase the speed of decision-taking, reduce the regulatory burden and favor EU integration.

The main lesson from the current crisis is that EU financial stability benefits from a commonly shared philosophy. This commonly shared philosophy appears in Europe in the area of Government intervention. The increased need for cross-border cooperation was initiated in a first Memorandum of Understanding in 2005 and has been reinforced with a Memorandum of Understanding signed by all Treasuries, Supervisors and Central Banks during last summer, to be implemented by the end of the year. A sense of urgency is instilled in the task of developing a stability framework with an explicit ex-ante, EU-wide, crisis prevention mechanism that increases confidence among national authorities that necessary actions will be taken; that information will flow; that there will be adequate representation of their interests in decision10 making and implementation; and that authorities at all levels (i.e., EU, national, institutional) will be accountable for the stability aspects they control. This Memorandum of Understanding covers crisis prevention, management and resolution.

Importantly, at the national level, stability frameworks should develop institutional mechanisms that ensure the ex-ante compatibility between microprudential and financial stability objectives. While there has been significant progress in setting standards (e.g., via the CRD), there is no agreement yet on a common set of procedures for early action. For example, there is an array of national triggers for remedial action, different degrees of discretion in the use of sanctions across countries as well as a wide degree of central banks' involvement in the supervision of national market liquidity and in the evaluation of market operators' liquidity risk management. The current crisis has shown that central banks' role in supervising liquidity management must become proactive and forward looking so as to be compatible with the dynamic nature of liquidity. In addition, cooperation between central banks and authorities responsible for microprudential supervision needs to be enhanced in several EU countries.

The mismatch between responsibilities and accountability in crisis management should be alleviated. Crisis management remains a national responsibility, but streamlined in the 2008 Memorandum of Understanding which has set the direction toward more information sharing and better allocation of responsibilities in case of crisis. However, the current crisis has shown that rapid, and low cost decision-making is possible. In the case of existing ELA arrangements, the same misguided outside observer reflects that it will be necessary to correct the current situation whereby host countries are responsible for ELA for subsidiaries and branches, but do not have access to supervisory information about branches, and thus, have no way of assessing the risks involved in the ELA operations they undertake. As a result, the distinction between liquidity and solvency, and the ensuing impact on the sharing of the costs of the operation, would remain opaque. Moreover, host country supervisors would not have the incentive to provide liquidity support because funds could flow back from a troubled branch to the parent company due to EU ring-fencing prohibitions. On the other hand, home-country authorities might delay providing information or taking crisis-management actions to avoid capital losses, reputational effects or political backlashes. So the home authority would not always have the incentive to keep small-country host authorities informed in an acceptable way. In turn, host country authorities would seek to retain as much intervention authority as possible. I beg to disagree.

Fact is that the broadening of the operational and instrumental framework of the ECB, especially concerning eligible collateral and broad institutional access to central bank liquidity, has created a kind of informal euro area liquidity assistance. Furthermore national ELA operations need to be flagged by the Governing Council and allow for extensive information sharing reinforced by bilateral contacts on a "know as you need" basis. Cross-border institutions benefited from nationally coordinated ELA, not only in the Benelux case of Fortis, but involved in other cases extensive cooperation between 2 or even 3 countries.

An EU-level crisis resolution framework, especially for systemic banks, is however pending. Like crisis prevention and management, crisis resolution was fundamentally national up to this crisis. Differences across countries' approach to financial institutions' failure vary enormously. Even for banks, there is little harmonization. Some countries have only a few bank-specific regulations; general commerce bankruptcy laws apply despite the winding up directive after BCCI. As shown again during the current crisis, banks have a liquidation value that is well below their value as going concerns. So, recapitalization is less expensive than liquidation. In the case of a large cross-border banks (LCBB), the problem is even worse as the focus of bankruptcy law is on the right of creditors in some countries, protecting debtors in some others.

Yet, the disparate history of legal regimes in the EU suggests that institutional changes will be slow. Also, despite moves in deposit insurance toward harmonization, notably via the Deposit Insurance Directive, there are glaring differences across countries regarding the definition of deposits, co-insurance, risk-based premia, and funding. This situation creates perverse incentives, uncertainty, and regulatory arbitrage opportunities.

Since the crisis, however, change seems to be faster. The provision of recapitalization funds and guarantees for bank debt, though nationally implemented, will follow common rules. Yesterday the Eurosystem agreed on 10 recommendations sent to national Governments covering pricing modalities, timing, eligibility criteria, etc.. At a cross-border level, as no EU agreement exists on the financing of insolvent institutions, home country authorities may be reluctant to spend resources that will benefit host countries, or will be faced with situations in which they will not be able to save financial institutions because they are "too big to save". On the other hand, host countries may not be able to restore the bank as a going concern because the subsidiary may not be viable. An EU-level framework with ex-ante fiscal cost sharing mechanisms should move national authorities' incentives away from a sole regard for the costs for the country. The recent approval by ECOFIN of a uniform EU deposit insurance limit is a step in the right direction.[3] Finally, an EU framework would reduce the costs of dealing with troubled LCBB by making transparent the conditions under which solvency support to a failing financial institution implies state aid and becomes incompatible with EU competition rules. The Commission has to this end empowered one Commissioner for rapid decision-making.

I wish to finish on a hopeful note reminiscent of Schumpeter's celebrated "creative destruction" concept. Technological developments, by changing economic agents' constraints, modify their actions and prompt a new equilibrium. Institutional changes also become necessary to preserve a level playing field given that asymmetric information, herding behavior, and the notorious difficulties of economic agents to measure the evolution of risk over time, make financial markets incomplete. Effective institutions should affect behavior and will, in turn, suggest the need for a new equilibrium. Therefore, the current crisis, by having sent the financial system way far from an old equilibrium, may end up being useful in bringing forward necessary changes to the EU financial stability framework. It may do so by moving discussions from a nearly exclusive focus on what can be delivered under the existing framework to what a framework of financial stability *should* deliver.

Thank you for your attention.

[3] The scheme increases the coverage of deposit protection to 100.000 Euros, removes all co-insurance, and is applicable to branches and subsidiaries.