Lucas Papademos: Strengthening macro-prudential supervision in Europe

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the conference on “After The Storm: The Future Face of Europe’s Financial System”, organised by Bruegel, National Bank of Belgium and the International Monetary Fund, Brussels, 24 March 2009.

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I. Introduction

This conference has provided an excellent forum for an enriching and stimulating debate on “The Future Face of Europe’s Financial System”, a subject which is both topical and highly policy relevant. In my remarks, I will focus on two issues:

- First, what are the key lessons of the ongoing financial crisis for EU financial supervisory policy;
- Second, what are the objectives and responsibilities of macro-prudential supervision, and what are the instruments and institutional requirements for the effective performance of macro-prudential tasks.

II. The lessons of the crisis for financial supervisory policy

A first lesson of the financial crisis is that it has been a consequence of factors and processes that have affected both the overall macro-financial environment as well as the behaviour of individual institutions and the functioning of specific market segments. It was the joint influence of both macro and micro factors that resulted in market excesses and the emergence of systemic risks of unprecedented magnitude and complexity.

At a macroeconomic level, large and persisting global imbalances, rapid credit expansion over a protracted period of time, in a benign environment of low inflation and high growth, fostered a huge increase in leverage, a significant underpricing of risk and a consequent divergence of asset prices from fundamental values. At a micro-economic level, financial innovations, notably the securitisation process, although in principle should have helped to better diversify and distribute risk, were implemented in a manner that fostered improper incentives and resulted in the loosening bank lending standards, the creation of complex and opaque products whose real value and embedded risk was difficult to assess, and the establishment of off-balance sheet investment vehicles that led to the concentration of (credit and market) risk and maturity mismatches that contributed to the severity and duration of the crisis.

A second lesson of the crisis is that the nature and magnitude of the systemic risk in the financial sector is not related only to the potential illiquidity or insolvency of large banks or other big regulated financial institutions, but it also depends on the degree of “interdependence” or “interconnectedness” between financial institutions and between markets. This “interconnectedness” reflects a variety of direct and indirect linkages in the financial system and it involves institutions and markets that are regulated as well as those that are not subject to sufficient, or any, regulatory oversight. This second category includes not only hedge funds but also off-balance sheet financial entities, such as structured investment vehicles, as well as the securitisation market, and the market for credit default swaps (CDS). In this respect, two points are relevant for the design of the regulatory policies. First, the size of some of the non-bank financial institutions and the overall magnitude of the activities of the “non-bank, non regulated sector” have become significant and can pose systemic risks. Second, and as a consequence of the first, the “interconnectedness” of all

institutions and markets implies that it is the "collective" behaviour of all that determines endogenously systemic risk and its potential impact on the real economy.

A third lesson is that the increasing financial integration in Europe and globally has important implications for the cross-border distribution and propagation of systemic risk and the appropriate institutional setting for the prevention and management of a crisis. More specifically, the regulatory framework and the supervisory arrangements in Europe must be broadly compatible with those in other large economic areas, notably the United States and vice versa. And within the EU, the growing presence and significance of cross-border financial institutions (the largest 43 cross-border banking groups in the EU accounted for 76 % of total EU bank assets at the end of 2007[1] requires the strengthening of the pan-European character of supervision.

A fourth and final lesson that I want to stress is that effective crisis prevention and management call for close cooperation and efficient information exchange between the supervisory authorities in various jurisdictions as well as between the central banks, whose tasks include the safeguarding of financial system stability, and the supervisors of individual institutions. The effectiveness of such cooperation, which is relevant both within countries, and across borders, crucially hinges on the exchange of relevant information in a timely manner.

What broad conclusions can we draw from these lessons, and more generally from the recent experience, for supervisory policy? Although the severity of the ensuing problems has differed across institutions and countries, overall the crisis revealed that micro-prudential supervision in many cases proved inadequate to identify, in a timely manner, the nature and size of accumulating risks and to impose appropriate remedial action. Moreover, although the build-up of financial imbalances, the underpricing of risk and the rise in the degree of leverage in the financial system had been identified as sources of potential instability by international institutions and central banks, including the ECB, their warning signals, which had become progressively louder over time, did not trigger appropriate responses either by market participants or by the authorities responsible for the oversight of individual financial institutions or specific market segments.

There is, therefore, a manifest need to strengthen both the macro-prudential and micro-prudential supervision of the financial system and to do so in a way that achieves valuable synergies and has a mutually reinforcing impact on the stability of the financial system. In particular, the role of macro-financial factors, of the interconnectedness of markets and institutions and of cross-border financial integration in determining the size, nature and propagation of systemic risk calls for the strengthening of macro-prudential supervision in Europe and globally. This should help prevent the recurrence of similar episodes of market excesses and corrections in the future, with disruptive effects on the real economy, and it should help ensure that the financial system is dynamically stable and resilient to shocks.

III. The framework for macro-prudential supervision in the EU

What are the implications of the lessons of the crisis of these broader policy conclusions for the appropriate design and the effective functioning of the EU supervisory framework? I will address this question by taking as a "frame of reference" the pertinent recommendations of the Report of the de Larosière Group that was broadly welcomed by the European Commission. The Report is a comprehensive and valuable contribution that deals with a wide range of issues concerning financial regulation, supervision and global cooperation. I will focus on the envisaged framework for macro-prudential supervision, as outlined in the two

[1] In the euro area, the largest 30 cross-border banking groups accounted for 73% of euro area total bank assets at the end of 2007.

recommendations, 16 and 19, both because of the importance of establishing such a framework – since it does not yet exist and is urgently needed – and because of the central role that the ECB and the European System of Central Banks are proposed to play.

The Report recommends that a new body – called the European Systemic Risk Council (ESRC) – should be set up, to be chaired by the ECB President, and which should function under the auspices and with the logistical support of the ECB. The new body should pool and analyse all information, relevant for financial stability, pertaining to macro-economic conditions and to macro-prudential developments in all the financial sectors. The general task of this body will be to "form judgements and make recommendations on macro-prudential policy, issue risk warnings, compare observations on macro-economic and prudential developments and give directions on these issues". Let me elaborate on two sets of issues: (1) the functions of the macro-prudential framework; and (2) a number of necessary conditions pertaining to instruments, institutional requirements and procedures for the effective performance of macro-prudential policies.

The main functions of the macro-prudential framework include:

- the identification and assessment of risks and vulnerabilities in the EU financial system (including all markets, institutions and infrastructures);
- the issuance of risk warnings; and
- the adoption of related recommendations on macro-prudential policies.

These functions could be complemented by other relevant tasks:

- the definition of specific macro-prudential reporting requirements for financial institutions to fill significant information gaps;
- an advisory role on EU regulatory measures that are relevant for macro-prudential supervision. This role could also include the identification of possible regulatory gaps stemming from financial innovation that could pose systemic risks.

The performance of these tasks requires the support of appropriate analysis and a comprehensive information base. The interconnectedness of financial institutions and markets within the EU but also globally implies that the monitoring and assessment of potential systemic risks should be based on a broad set of relevant macro-economic and macro-financial data and indicators, as well as information provided by micro-prudential supervisors and information obtained from market intelligence. The development of the appropriate structure and the procedures for bringing together all types of pertinent information, also in a manner that ensures strict confidentiality in the use of micro data, will represent a major challenge, which will require analytical sophistication, market knowledge and supervisory expertise. Moreover, the monitoring of risk exposures across institutions, markets and borders will have to rely on the close cooperation with the relevant supervisory authorities (banking, insurance and securities supervisors) within the EU and globally.

The analysis necessary for carrying out the macro-prudential tasks can partly be based on the economic and monetary analyses undertaken by central banks for the formulation of monetary policy. But it will have to be complemented with the further development and use of models for macro-stress testing and of financial stability indicators. These analytical tools can help monitor, and assess the implications for systemic stability, of risk exposures across institutions and markets, for instance, the common credit exposures of interconnected financial institutions to other firms, sectors or regions; or the market risk exposures through holdings of securities or common positioning of interconnected institutions in relevant markets (i.e. potentially leading to so-called "crowded trades").

Macro-prudential analysis and supervision focus, by definition, on the monitoring and assessment of systemic risk in the whole financial sector. This risk, which can emerge both during the upswing and the downswing of an economic and financial cycle, reflects the

effects of macroeconomic forces and the collective behaviour of institutions and other market participants. Central banks, whose primary objective is the preservation of price stability –a necessary though not sufficient condition for the stability of the financial system– and which maintain close links with the money and financial markets in order to perform their monetary policy tasks, are well suited to be the authorities mainly responsible for macro-prudential supervision. In the EU, the ECB and the European System of Central Banks stand ready to carry out the analytical and statistical work necessary so that the new EU body responsible for macro-prudential supervision can perform its functions effectively. At the same time, the involvement and cooperation of supervisory authorities is also essential. In addition to the proposed participation of the chairpersons of CEBS, CEIOPS and CESR, as well as one representative of the European Commission, the heads of national supervisors could be invited to join the national central bank governors as required by the subjects being discussed.

Appropriate links should also be established between the ESCB and the proposed European System of Financial Supervision. These links should contribute, inter alia, to effective information-sharing as well as to providing an additional channel through which the "output" of the deliberations of the new EU macro-prudential supervisory body will be communicated to the micro-prudential supervisors and help trigger appropriate policy measures. This could include changes to capital requirements and liquidity buffers in order to respond to identified emerging systemic risk. And this observation brings me to my last two points.

The de Larosière Group emphasised that once a macro-prudential risk warning has been issued "it must be clear to everyone who should act and according to which timetable". It is therefore essential that a suitable mechanism is in place to ensure that the required supervisory or regulatory actions are implemented in an effective and timely manner.

No reflection on the appropriate macro-prudential framework for Europe would be complete without due consideration of its international dimension. This global financial crisis has underscored the importance of concerted policy responses globally. The early identification and assessment of risks and vulnerabilities, the issuance of risk warnings, and the adoption of the related macro-prudential policies should be key responsibilities in a reformed global framework for financial oversight, in which the IMF and the FSF should play a key role, but all relevant parties, including the new EU macro-prudential supervisory body, should be closely involved. Our European framework should fit in, and be compatible with the global approach to be adopted.

IV. Conclusion

In conclusion, let me emphasise that the establishment of the proposed EU body responsible for macro-prudential supervision, the effective performance of its tasks, the efficient translation of its risk assessments and macro-prudential policy recommendations into appropriate policy measures will require addressing a number of legal, institutional and organisational issues. One such issue is the institutional relationship and fruitful collaboration between the European Systemic Risk Council and the envisaged European System of Financial Supervision. We should all contribute to addressing these issues in a constructive and timely manner, for the strengthening of macro-prudential supervision in Europe is an important and urgent policy objective.

Thank you very much for your attention.