Jean-Claude Trichet: Macro-prudential supervision in Europe

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Ladies and Gentlemen,

I am very pleased to be in London today and would like to thank *The Economist* for the opportunity to deliver this City Lecture.

As regards the topic, I thought that this would be an opportunity to reflect on the future macro-prudential supervision in Europe. We are gradually beginning to see beyond the current crisis and consider ways to strengthen the resilience of the financial system. This is a project to which macro-prudential oversight can make an important contribution.

I will begin by saying a few words on the current condition of the euro area financial system. Then I will make the case for macro-prudential supervision in the single market of the European Union and discuss the issue of the conduct of macro-prudential supervision. I will conclude with some remarks on the issue from the point of view of the financial sector itself.

1. The current condition of the euro area financial system

Let me start by saying a few words about how we at the European Central Bank regard the current situation in the financial system in the euro area. The ECB's Vice President, Lucas Papademos, will present our comprehensive assessment very soon, based on the publication of the next edition of the ECB's Financial Stability Review.

As is the case in all significant financial systems, an overall assessment of the health and vulnerability of the euro area financial system calls for a very deep analysis. There is in particular a considerable degree of diversity in the financial performance of large financial institutions in the euro area. Some are still in the process of deleveraging, while others show a rising appetite for risk.

It is also quite a challenge to disentangle what can be considered "self-sustainable" developments in the recent market recovery from those developments that might be highly dependent on the unprecedented programmes of official support to the financial system that are still in place.

As a result of these support measures – in combination with the fiscal stimulus and the improving macroeconomic outlook – the strains on the euro area's financial system have been clearly diminishing over the past few months, and a financial market recovery has begun, which, in some areas, looks very significant.

Since March this year, improvements in financial markets have been broad-based. Euro area money market spreads, especially at shorter maturities, have narrowed continuously and remain at low levels. There are also signs that unease about counterparty credit risk is abating. This is reflected in longer-term spreads between interbank deposits and repo interest rates, which have also steadily declined. Corporate bond and equity markets have continued to recover.

These developments improved in the financial performance of banks in the euro area. Yet the crisis in securitisation and structured products – and the consequences of an irresponsible originate-and-distribute model – are not yet behind us. And the next big challenge for banks is already being felt.

That challenge stems from the consequences of the impact of the financial crisis on the real economy, notably the deterioration in the quality of loan portfolios. There has been a surge in provisions for loan write-offs. In the third quarter of this year, the provisions of large euro area banks, measured as a percentage of total loans, were significantly higher than in previous periods. Depreciation of the loan portfolios has led to another wave of write-downs, initiated in the first half of the year, following the first wave of write-downs in the second half of 2008, which arose mostly from mark-to-market losses on structured products.

Not surprisingly, given its nature, this second wave is affecting a wider range of institutions. It also emphasises the scale of the challenge that banks face when seeking to strengthen their profitability.

So even though regulatory capital ratios for large euro area banks now broadly stand at higher levels than before the crisis, the necessity to increase capital must be stressed in the case of a number of institutions. I urge banks to take full advantage of the recent recovery in their profitability to strengthen their capital positions, rather than to distribute a large part of their profits or to pay out unwarranted levels of compensation or bonuses.

Stronger balance sheets will help the banks to fulfil their essential function to the economy – that is, to lend. The ECB has provided exceptional measures, which we call ‘enhanced credit support’, not for the banks themselves but to enable them to finance the broader economy. They must take up and maintain this responsibility.

As I have indicated, the heart of the financial system is starting to beat at much more normal frequencies again, but nobody should overlook the many wires and tubes through which emergency medicine continues to be administered.

A key question for us at the ECB, as for other central banks, concerns the timing of the withdrawal of the medicine to avoid the threat of addiction or dependency. We have made clear that we will unwind enhanced credit support in a timely and orderly fashion.

Last week we began to initiate, in a gradual fashion, the unwinding from some of these exceptional measures. We are helped by the fact that all our exceptional measures were designed with eventual phasing-out in mind.

2. The case for macro-prudential supervision in the EU

Let me now move to the core topic of my lecture today. The three questions that I would like to address are: why is macro-prudential supervision desirable for the European Union; how should it be organised; and what are the implications for the financial sector?

Let me look at the question of desirability first.

The financial crisis has been revealing in many respects. It has revealed the scale of the potential fallout from the failure of large financial institutions. It has revealed the fragility of the financial system to features and trends that cut across institutions, markets and infrastructures. And it has illustrated the amplitude of the consequences of the adverse feedback loop between the financial system and the real economy.

All three elements I have just described are key features of systemic risk: first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the financial system; and third, the close links with the real economy and the potential for strong feedback effects.

In short, the crisis has revealed the fundamental importance of systemic risk. The purpose of macro-prudential supervision is to identify sources of systemic risk and recommend remedial action.

Of the three elements I have mentioned, contagion and the link to the real economy are the least novel in this financial crisis. They have been observed in many previous crises.

The element that had been more unexpected in the current crisis is the rigour with which systemic risk has been triggered by the collective behaviour of financial institutions and the ways in which they interact in financial markets. The crisis has highlighted the importance of improving our understanding of interconnectedness in the financial system, both via the direct links between financial institutions and the indirect ones created in financial markets.

The crisis has taught us that major risks can emerge from within the financial system itself. It was not the real economy that threw the financial system into disarray, but the reverse.

Endogenous risks – risks that emerge from within the financial sector – can have many causes. They may arise, for example, because large parts of the system rely on the same sources of funding, or because they have similar exposures – to rising financial imbalances, to currency mismatches and to widespread mis-pricing of risk.

We have also seen that turbulence can arise from relatively modest initial shocks. The system is so interconnected that what looks stable can turn out to be "meta-stable", which means potentially highly instable. Snow on mountain slopes can be meta-stable, looking pristine and tranquil yet turning into an avalanche after only a minor disturbance.

The meta-stability of a system is a complex concept, which calls for analysis of the interplay between diverse phenomena. In financial systems, these phenomena include herd behaviour, complex networks of relationships between counterparties, and contagion from common or correlated exposures to particular asset classes. They also include the undesirable pro-cyclical effects of prudential rules, of accounting rules, of credit rating agencies, and of compensation systems that put undue emphasis on short-term earnings.

On this last point, I will say that the so-called bonus culture is one of the many factors that can drive the financial system in the wrong direction – away from intermediation to self-referential speculation; away from medium-term stability to short-term orientation; and away from being a service sector to being a self-serving sector.

I have outlined the key features of systemic risk that underlie the need to establish a new framework of macro-prudential supervision. In the case of Europe, there is still one more reason, and that is the existence of the single European market. The single market makes the financial system much more fully integrated than it would otherwise have been – in terms of how it is set up, in terms of how it is regulated and in terms of the linkages with the real economy that itself is structured by the single market of the EU.

Cross-border and cross-sectoral financial integration within the EU is fostered by competition, freedom of establishment and the free flow of capital. The extent of integration within the EU's financial sector is a substantial achievement and it should be safeguarded in the aftermath of the crisis. About 40% of foreign claims by UK banks are in the euro area, and roughly the same share can be observed in the opposite direction.[1]

Therefore, we Europeans have all the reasons to create a framework for macro-prudential oversight at the level of the single market of the 27 member countries of the European Union. The single financial market is a crucial component of the overall single market project, and macro-prudential supervision should enhance the resilience of this market.

3. The conduct of macro-prudential supervision

The desirability of macro-prudential supervision is clear. And from that naturally spring the objectives – to mitigate and prevent systemic risks to financial stability in the EU on the basis of identified vulnerabilities and systemic risk assessments. Now we must turn to my second question and ask how such supervision should be conducted.[2]

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1 BIS data on foreign claims by nationality of reporting bank (ultimate risk basis), 2009Q1.

2 See also L. Papademos, "Financial stability and macro-prudential supervision: objectives, instruments and the role of the ECB", Speech of 4 September 2009.

Almost everywhere in the world, central banks are seen as playing, or called to play, an important role in macro-prudential supervision.

In my view there are very good reasons for that. On top of their key involvement in the financial sector, central banks possess three main features that are qualifying themselves for that function: they are, by their very nature, anchors of stability; they are medium-term oriented; and they are independent.

Central banks have traditionally been active in financial stability analysis. Of course, from financial stability analysis to macro-prudential supervision is yet another step. Financial stability describes the overall resilience of the system, focusing on imbalances and stresses in the financial system in the aggregate. While macro-prudential supervision takes a similarly broad view, it must also focus on specific sources of instability or specific groups of financial institutions, adding the policy component to the oversight function.

Overall, the effectiveness of macro-prudential supervision depends on many inputs, including quantitative or qualitative information from supervisors, regulators, macroeconomists, market participants and other stakeholders in seeking to identify systemic risks and proposing policy responses.

The analysis for systemic risk surveillance and assessment is indeed very demanding,[3] and as much of the credibility of the entire framework depends on it. In my view, the most difficult pieces will be the analysis of the implications of interlinkages in complex systems and understanding how a potential risk might spread throughout the system.

Risk surveillance and risk detection call for early warning indicators and approaches capable of indicating when the financial system as a whole or parts of the system are approaching a “danger zone”. Risk identification calls for the monitoring of a comprehensive set of macro-financial variables and forward-looking indicators. This task will require a detailed understanding of the channels through which emerging risks are transmitted. I spoke yesterday in Cambridge about the analytical challenges underlying systemic risk and the various research avenues that are being pursued.

The other challenge for effective macro-prudential supervision concerns the quality of recommendations themselves. Here, the key lies in their specificity. The more specific recommendations are, the easier is their implementation in concrete actions. It is here where knowledge of supervisory and regulatory authorities has to enter the equation. It is an important component of macro-prudential assessments and, in particular, in the design of recommendations on the appropriate policy actions needed to contain the build-up of financial vulnerabilities or to mitigate material risks.

Specific warnings require close input from supervisors, regulators and from all public and private stakeholders. This is the reason why a credible framework of macro-prudential supervision should be set up very broadly, combining a variety of perspectives and closely coordinated with micro-prudential supervisors.

Macro-prudential recommendations will not be addressed to individual institutions. This remains the sole prerogative of micro-prudential supervisors. Instead, they will be addressed to regulators, supervisors or other authorities so as to foster regulatory and supervisory policies. These authorities have instruments which can steer variables such as maturity mismatches, excessive credit growth, leverage, or the risk appetite of market participants. While it might not be desirable or feasible to target these variables directly, prudential policy instruments – individually or in combination – can affect them indirectly.

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[3] The Bank of England released an interesting analysis of the role of macro-prudential policies in November 2009, highlighting many of the analytical challenges as well. The ECB has undertaken a series of research in the field of systemic risk.

Macro-prudential supervision will not and should not be a substitute for micro-prudential supervision. Rather, it should complement micro-prudential supervision; it has been conceived because the deep integration of the financial system has made it too difficult to ensure systemic stability while focusing on financial institutions one at a time.

In providing specific warnings and recommendations, based on a comprehensive analysis of systemic risk, an effective framework of macro-prudential supervision can close the gap between the analysis of financial stability and micro-prudential supervision.

Setting up a formal framework for macro-prudential supervision will also help to coordinate macro-prudential policies more effectively at the international level. This will be particularly important for the EU, given the depth of its financial integration with the rest of the world.

4. Implications for the financial sector

Let me turn to the last part of my lecture and reflect on the possible implications for the financial sector.

The financial sector has an important stake in a well-functioning macro-prudential supervision framework and will ultimately benefit from it. The industry should be closely involved in such a framework, as information and insights from market participants will be essential inputs.

Any well-functioning macro-supervisory framework needs the support of market participants, because a rigorous monitoring of systemic risks will require continuous market intelligence. Contact with market participants will be essential for detecting important trends, such as growing financial imbalances, convergence of business models, similarities in investment strategies and innovations in financial instruments – to name just a few.

It will be of immense value to establish a structured dialogue with the financial industry to this end. Anecdotal evidence will be of little relevance if there is no possibility to drill down to the sources of risk on the basis of well-founded information and a regular dialogue with market participants.

I understand that there may be concerns that this will impose an additional reporting burden on the industry. In my view, this should not happen. To the extent that macro-prudential oversight requires micro-prudential data, the latter should be available from supervisors, and full confidentiality will be ensured. Any additional reporting would be exceptional.

Macro-prudential supervision should also avoid leading to an excessive burden of regulation. The legal principle *non bis in idem* applies to regulation: the financial sector cannot be regulated twice. The aim of macro-prudential supervision is to provide better regulation – and if possible much better, not in quantity but in quality.

Indeed, I foresee several benefits for the financial industry from well-functioning macro-prudential oversight.

The first and main benefit is of course a more stable financial system, which is as much to the advantage of all players in the industry as it is to everyone in the wider economy.

The second benefit is, as I have just mentioned, better regulation, rather than more regulation. Better regulation combines micro-prudential *and* macro-prudential perspectives. Macro-prudential policy advice should allow market participants to internalise the potential effects of systemic risk in conducting their business. This should enable financial institutions to improve their forward-looking capacity in decision-making, taking corrective measures with sufficient lead time, and being more resilient to market tensions if and when they arise.

The third set of benefits lies at the technical level. The analytical progress that will go hand in hand with a strengthening of macro-prudential oversight should benefit financial institutions' in-house risk analysis.

This applies in particular to the large, complex and interconnected institutions, on which a substantial part of the macro-prudential analysis is likely to be centred, as these institutions tend to contribute significantly to the level of risk of the overall system. For example, there are likely to be benefits for the further enhancement of financial institutions' internal models, including stress testing, notably by taking account of system-wide factors and macro-financial variables.

A better understanding of the concept and measurement of systemic risk will lead to more accurate indicators of aggregate leverage, correlation and concentration of exposures to specific asset classes and of a firm's interconnectedness.

With a view to enabling better measurement of key elements in systemic risk analysis, it is the responsibility of financial institutions to continue to enhance the transparency and granularity of their individual reporting. This could improve, for example, individual firms' assessment of counterparty risks. Better measurement will also allow for better management. Risk management decisions will be better informed. And financial institutions' preparedness for specific risks will be enhanced.

5. Conclusion

Let me draw to a close by referring to the concrete legislative proposal currently underway that will establish a macro-prudential framework for the EU. This is the planned establishment of a European Systemic Risk Board (ESRB) on the basis of the proposals of the High-level group chaired by Jacques de Larosière.

I am pleased to see that there has been broad support for the legislative proposals in the Ecofin council, and I would like to pay tribute to the European Commission and the Swedish Presidency for preparing and advancing these proposals. The European Parliament, which has always been very committed to advancing European supervision at the micro and the macro level, is currently examining these proposals and preparing its decision. In my hearing on Monday this week, I very much appreciated the opportunity to present to the Parliament's Committee on Economic and Monetary Affairs our perspective on this matter.

The ECB, as an institution of the European Union as a whole, as an institution of the 27 EU Member States, has been invited to provide support to the ESRB. The Ecofin concluded that the ECB should provide analytical, statistical, administrative and logistical support, in close cooperation with all the national central banks from the 27 states.

The ECB's General Council, which, together with the three heads of the European Supervisory Authorities and the Commission, will be the nucleus of the ESRB, has been meeting at least four times a year since 1999. The General Council prepares and approves the Convergence Reports, contributes to the functioning of the exchange rate mechanism ERM II and is involved in a wide range of central banking tasks, including legal opinions, statistical issues and accounting, as well as a regular review of monetary policies in the EU.

As central bankers, we are aware of the challenge of jointly contributing to the stability of the EU financial system. As I have highlighted, the enhanced resilience of the financial system should stand out as the highest-order objective of the institutional and market reforms that are being implemented in the wake of the financial crisis.

Macro-prudential supervision in the EU will count on the active role of the 27 governors of the National Central Banks, including the very active involvement of Mervyn King as the governor of the Bank of England, and on the full participation of the heads of the European Supervisory authorities and the Commissioner. It will count also on the close link to the national supervisory authorities, particularly here the FSA and its chairman, Lord Turner. Set up in this way, it will provide a significant contribution to the resilience of the financial system.

We have to succeed. At stake is not only the stability of one of the world's largest financial systems, but also the support from the over 490 million citizens in the European Union who are watching our efforts very closely. We have counted very heavily on their support for the financial system, and they would not forgive us if we had to do so a second time.

Thank you for your attention.