Jean-Claude Trichet: Strengthening the European Union's framework for crisis management

Opening statement by Mr Jean-Claude Trichet, President of the European Central Bank, at the European Commission Conference "Building a Crisis Management Framework for the Internal Market", Brussels, 19 March 2010.

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Ladies and Gentlemen,

I would like to thank the Commission for inviting me to today's conference. I trust that the discussion will help to identify avenues that will strengthen the European Union's framework for crisis management and resolution for the years to come.

The evolving crisis

Reflecting on the crisis from today's perspective, I would say that what is now called "the crisis" is a deeply evolving phenomenon. It evolved from a crisis of liquidity into a full-scale crisis of banking and finance, and then into a global financial and economic crisis. And as we are all well aware, a great deal of attention is currently focused on fiscal policy and public finances.

At the same time, policy-makers around the world have so far fended off a number of threats: a global meltdown of finance, a downward spiralling of the economy and a massive increase in global levels of unemployment.

Fundamentally, this is a crisis of valuation. But it is also a crisis that has led us, and continues to lead us, to fundamental re-evaluation.

We have had to re-evaluate our understanding of the nature of risk of major market disruptions. We have had to re-evaluate the potential responses in terms of the implementation of monetary policy and the effectiveness of fiscal policy. And as citizens and policy-makers, we have to re-evaluate our understanding of the role of finance in our economies and our societies.

In particular, we must consider fundamental questions about the relative importance and limits of the pure financial "game" in markets, about the potential abuse of market power, and, most importantly, about the function of the financial sector in the broader economy. In my view there is a clear litmus test for this function: whether or not finance serves the real economy.

Financial reform therefore must ensure that finance is properly reconnected with the real economy. Reform needs to go beyond the banking sector on which so much attention has been focused. We also have to look very closely at non-bank financial institutions and at the set-up and functioning of financial markets.

Financial markets are not always efficient. They are also not always broad, liquid and representing a fair competition of views and positions. Quite often, specific market segments can be oligopolistic, dominated by a few large actors. In such oligopolistic markets, information handling is particularly problematic, as views by dominant actors can evolve into fashions and set off trends that, through herding, move valuations out of line with what is warranted by medium-term fundamentals.

As we now all recognise, if left on its own, finance has the potential to spiral out of control, for example through leverage cycles, triggering financial disruption, wealth destruction and economic hardship for our people.

Therefore, one of the greatest challenges for economics and public policy at this time is to restore financial and economic stability, to rebuild confidence in the prospects for our economies and to improve the future functioning of financial systems.

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The main agenda for today is what progress we can make in building a crisis management framework for our financial system at the European level. I will make some remarks on that key issue in a moment. But first I would like to reflect on what we have learned from the crisis in terms of the fundamental issue of systemic risk.

Systemic risk

A pre-condition for meeting the challenges of crisis prevention and crisis management is a deep understanding of the nature of systemic risk.

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.

To identify sources of systemic risk and recommend remedial action will be the task of macroprudential supervision in the EU, and the cross-border crisis management framework will help to handle large and complex financial intermediaries whose disorderly failure could pose systemic risks.

A crisis management framework

The national legal and institutional arrangements in a number of Member States have sought to improve the framework for prudential supervision and financial stability. We at the European Central Bank have supported such improvements.

One key remaining issue is to accompany the greater interdependencies between national financial systems and thereby bolster the process of EU financial integration that is so desirable from a welfare point of view. This requires appropriate action at EU level to address the possible systemic impact of failing cross-border financial institutions. The ECB therefore fully supports the Commission in its initiatives to develop an EU-wide resolution framework and remove obstacles to effective crisis management pertaining to EU cross-border financial institutions.

The Commission has suggested a very useful classification of the main issues under discussion into three areas: *early intervention* by supervisors; *bank resolution*; and *insolvency proceedings*.

Let me devote a few words to each of them.

First, in the area of *early intervention* the enhancement of cooperation among supervisory authorities is important, when they address an ailing cross-border financial institution. It can be improved by achieving convergence as regards a minimum set of tools available to the supervisory authorities involved. This may require also a common terminology as regards for instance the types of reorganisation measures to be used for financial institutions.

Second, as regards *bank resolution*, a priority is to pursue an enhanced and more coherent framework for the action of *supervisory and resolution authorities*. To avoid moral hazard, authorities should be ready to intervene with appropriate actions to contain the possible impact on financial stability and, where appropriate, ensure an orderly winding-up of the affected financial institution.

In the Single Market, efforts should be made to facilitate coordination of the actions of national authorities involved in the resolution of a cross-border banking or financial group. Over the medium term, it would be helpful to achieve closer institutional convergence, with an enhanced role for the authorities within the resolution process, by recognising in particular their leading role in the administration of ailing financial institutions, in full respect of the due role of the judicial system.

Third, as regards *insolvency proceedings*, new initiatives are required to promote further harmonization at the EU level. Today, national legal regimes are still diverse in terms of the rules and procedures that apply. It is recognised that harmonization at EU level may be difficult to achieve, but it should be underlined that it is key in any crisis resolution. Therefore, utmost efforts should be devoted to assessing outstanding problems and identifying possible ways forward. The ECB strongly supports the recent establishment by the Commission of a group of experts to pursue this aim.

There is one central challenge to all crisis management frameworks and this is speed. The rapidity of unfolding developments is one of the greatest challenges for policy makers. And even though financial crises are by no means new phenomena, the speed of their transmission has accelerated tremendously over the past few decades. The unfolding of the sovereign debt crises in the 1980's occurred over the course of years, the Asian Financial crisis developed, at its peak, over months. And last intensification of the present crisis, starting in September 2008, has spread around the globe in the course of half-days. Many factors have contributed to this acceleration, including the process of global financial integration, the increasing leverage in institutions, the technological advancements that allow for an instantaneous transmission of information world-wide and the accumulation over a long period of time of unsustainable global imbalances.

Hence, a key message for all crisis management frameworks is that they need to be able to cope with the speed of which financial developments can unfold.

The role of infrastructures

Policy action should not concern only banks but also the system as a whole, in particular addressing market functioning, including those of CDS. The current reflections at international level include also initiatives aimed at strengthening the core financial infrastructures and markets. Indeed, it is essential that conditions are in place to ensure that the financial system is able to withstand any possible shock and that financial infrastructures are strengthened to reduce the risk of contagion.

Moreover, regulators have to ensure that financial market participants are behaving in full compliance with the rules and that no additional source of risks would derive from improper behaviour.

In this context, attention has been attracted at the current juncture by the Credit Default Swaps (CDS) market.

I would like to highlight the importance that certain financial instruments, which were introduced in consideration of their positive effects for the hedging of risks, should not be misused in a speculative manner. I share the consensus at global level that regulators should be equipped with appropriate tools to be able to investigate and act in an effective and coordinated manner. We need more transparency in CDS markets, and so do investors.

Transparency of markets is a public good. Authorities must be able to gather information, to assess possible risks for financial stability and detect possible improper conduct.

In this respect, a key priority in terms of enhancing the resilience of the CDS markets is the establishment of central counterparty facilities. Such CCPs will help, in particular, to diversify and share risk exposures and their margining procedures will reduce the incentive to take excessive risks. Moreover, CCPs will deliver more of the much needed transparency for all parties involved.

Conclusions

The defining characteristic of any financial crisis is a collapse of confidence. The defining characteristic of the current crisis was a loss of confidence that seemed to permeate the whole world and almost instantaneously.

At the height of the crisis – when irrational exuberance had turned into excessive pessimism – I repeatedly stated that regaining confidence was of the essence. Since then, confidence in the short term has been restored, not least because of bold and courageous policy actions around the globe.

Going forward, we need to strengthen longer-term confidence, and that requires policy frameworks that will be robust against future challenges.

That is the agenda on which I know we all plan to make some progress today.

Thank you for your attention.