Gertrude Tumpel-Gugerell: Towards a safer financial system

Intervention by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the US Financial Services Roundtable, Brussels, 28 June 2010.

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Ladies and gentlemen,

I am very pleased to meet you today here in Brussels to discuss the post-crisis regulatory agenda from a transatlantic perspective.

The costs of the crisis have been tremendous on both sides of the Atlantic. Credit market related losses amount up to 731 bn. US dollar in the US and 272 bn. US dollar in the euro area. Capital had to be raised due to the crisis of 519 bn US dollar in the US and 288 billion US dollar in the euro area. Moreover governments on both sides of the Atlantic have committed support to the banking sector of up to 28% of GDP. So, there is no doubt that this crisis has come at the cost of substantially lower profits and great loss in overall income. Therefore, looking at these facts makes one thing very clear: We have to come up with a global reform of the financial system, so to prevent such deep crisis from occurring again.

Indeed, it has been one of the key lessons from the financial crisis that financial stability in our highly interconnected financial system can only be achieved through globally consistent and concerted efforts. Leadership of both public and private decision-makers in sustaining an intense international dialogue is therefore essential. Today's visit of the US Financial Services Roundtable is a very welcome initiative by leaders of the financial services industry to this end.

The extraordinary nature and consequences of the global financial crisis have demonstrated the need to reform the financial system. Various weaknesses have been detected and under the aegis of the G20 a comprehensive set of measures have been agreed upon. It is envisaged to strengthen both macro- and micro-prudential supervision as well as to enhance the use of market infrastructure. These measures will need to be complementary and supplementary to one another in order to have the desired effect. For this an intense international dialogue is key.

The global agenda for strengthening the financial system is very broad and I will not be able to cover all areas comprehensively today. I will therefore limit my speech to those areas of reform which are of particular importance. I will highlight some important areas as regards the regulatory reform, will touch briefly upon the supervisory reform and will then elaborate on the reform priorities in the area of market infrastructures.

Regulatory reform

The crisis has shown the importance of containing the excessive build-up of leverage in good times and enhancing the overall quality of capital with a view to strengthening the resilience of the financial sector. **The package prepared by the Basel Committee covering capital and liquidity reform proposals** is very comprehensive and addresses these issues by improving the quality, consistency and transparency of capital for credit institutions, as well as developing a framework for liquidity risk. [The main elements of the proposals are: First, to improve the quality of capital, especially Tier-1 capital to improve loss-absorption on a going concern basis. Second, the introduction of a non-risk-based leverage ratio as a supplementary measure to the Basel II risk control framework aims at curbing the excessive balance sheet growth we have witnessed. Third, the introduction of a range of measures, intended to mitigate the inherent pro-cyclicality of the financial system. And lastly, the introduction of capital buffers and forward-looking provisioning should ensure that the financial system absorbs the shocks and thus evening the volatility of the financial and real economic cycles.]

As you know, quantitative impact assessments have been conducted in order to assess the cumulative impact of the reform on financial institutions and on the real economy. As the preliminary results will be discussed at the July meeting of the Basel Committee, it would be premature to take a position on matters such as the desirable calibration. But let me just make two points. Firstly, from a conceptual point of view the ECB supports the proposed measures, particularly in light of the lessons learned from the crisis. Secondly, the ECB is of the view that notwithstanding the outcome of the impact assessments, we should not weaken the standards. It would be preferable that where relevant a longer transition period is agreed upon, balancing the need for enhancing banking stability and maintaining the stable provision of credit to the economy.

The crisis has also highlighted the particular importance of so-called systemically important financial institutions (SIFIs). Therefore another important part of the regulatory reform is the need to **reduce the moral hazard associated with systemically important financial institutions**. It will be key to find ways how SIFIs can internalise the potential costs they pose to the financial system. This could be achieved by the introduction of additional prudential measures, for instance through capital surcharges or contingent capital instruments, liquidity surcharges, more intrusive supervision, and/or the introduction of bank levies.

Although work is still underway and the Financial Stability Board is expected to provide recommendations to the G20 summit of November in Seoul, the European Council has recently agreed that EU Member States should introduce systems of levies and taxes on financial institutions to ensure fair burden-sharing and to set incentives to contain systemic risk.

As regards these initiatives, I would like to underline that the ECB has always been supportive of exploring the feasibility of such measures. However, for such measures to have the desired effect, it is important that an internationally coordinated solution is ensured. I am also of the view that any contribution by financial institutions should be complementary and coherent with supervisory and regulatory regimes. Sequencing of the implementation of measures is thus of utmost importance. Finally, it is important that the higher overall cost of funding is not passed on to the customers, for instance in the form of higher lending rates/fees or lower remuneration on deposits.

Another important area of regulatory reform is the efforts underway to achieve a single set of **high-quality global and independent accounting standards** by June 2011. In order to have a sound regulatory framework having high-quality and convergent accounting standards is crucial. We have to ensure that the current gap between the IFRS and US GAAP narrow rather than widen. It seems that the current FASB proposals on classification and measurement of financial instruments would result in more financial instruments to be measured at fair value, leading to an overall expansion of fair value accounting. Accepting this would not address some of the key lessons from the financial crisis, namely that fair value accounting does not always provide decision-useful information and it may exacerbate pro-cyclical effects. In addition, an expansion of fair value accounting would be in direct contradiction to the “mixed measurement model” as endorsed by the IASB, and therefore represent a major setback on achieving accounting convergence.

Supervisory reform

Let me turn to briefly touch on the progress with the supervisory reform. If there is one uncontested lesson from the crisis it is the need to further develop the capacity of the authorities to conduct macroprudential supervision. The ultimate aim of macro-prudential policies is to contain the build up of financial vulnerabilities and ensure that the financial system is able to withstand their unwinding, minimising potential spill-overs to the real economy.

An effective macro-prudential framework aims at delivering a thorough analysis of systemic risks, as well as the formulation of appropriate policies to address such risks identifying, in a timely fashion, the emergence and build up of critical vulnerabilities, and deciding on effective (pre-emptive) intervention.

In Europe a new body will be set up: the European Systemic Risk Board (ESRB). It will be responsible for the macro-prudential supervision of the EU financial system. The key task of the ESRB will be to identify and assess risks to the stability of the EU financial system and issue risk warnings when the identified risks appear to be significant and policy recommendations for remedial action. I am happy that with its involvement in the ESRB, the ECB will continue to play an active role in safeguarding the financial stability in Europe.

Financial Market infrastructures

Let me now turn to the priorities as regards financial market infrastructures. Financial market infrastructures underpin the stability of the financial system. By applying highly sophisticated standardised risk management procedures and enabling multilateral netting and risk-sharing, infrastructures provide both very resilient and efficient risk management services to their users. Market infrastructures can also act as centralised sources of information for authorities and the public, thereby enhancing market transparency and facilitating the early detection of financial imbalances. Furthermore, by interposing themselves between trading counterparties, infrastructures can reduce the interconnectedness between major financial institutions and the associated contagion risks. Therefore, it might not be a surprise that market infrastructures have been soundly withstanding the storm of the financial crisis. Still, I would like to draw your attention to three main policy priorities regarding financial infrastructures in light of the lessons from the financial crisis.

The ***first priority*** relates to the **development of financial infrastructures in those markets where they are not yet sufficiently used or available, notably in OTC derivatives markets**. The crisis has shown that markets with adequate infrastructures and hence proper risk management and risk provisions have proven to be more resilient than markets without such infrastructures, such as the OTC derivatives markets. Therefore, expanding the use of central counterparties (CCPs) in these increasingly systemically relevant markets is a key measure to reduce counterparty and operational risk. Another important step is the mandatory reporting of all trades to centralised trade registries, so-called trade repositories, in order to enhance market transparency. In my view, if CCPs and trade repositories for credit default swaps had been available before the Lehman default, Lehman's CDS exposures could have been managed in a much more transparent and resilient way and could have mitigated the negative chain reaction on CDS markets that followed the demise of Lehman.

CCPs and trade repositories for OTC derivatives are ultimately beneficial for all stakeholders. Still, there are the well-known challenges of effective collective action in the context of the provision of public goods. Hence, private sector efforts alone may not suffice to foster sufficient progress towards the use of CCPs and trade repositories for OTC derivatives. It is therefore important to adopt and implement the regulatory requirements for the mandatory central clearing of all eligible products and the reporting of trades to trade repositories in a timely manner. Given, however, the global nature of OTC derivatives markets, it is clear that such regulatory tools will only be successful if they are applied in a coordinated manner around the globe. I strongly support the recently launched work of the Financial Stability Board to develop common approaches to fostering the central clearing of eligible OTC derivatives as well as to expand the range of potentially clearable products through enhanced standardisation.

The ***second priority*** relates to the need for **updated and globally consistent requirements to ensure the safety and soundness of financial infrastructures**. By nature of their business, financial infrastructures concentrate systemic risk, owing to their large size, their limited degree of substitutability and the strong web of mutual interdependencies across infrastructures, e.g. arising from exposures to the same large participants. Increased reliance on market infrastructures across financial markets further underlines the importance of effectively addressing this risk. Therefore, it is crucial to ensure that CCPs are able to manage these specific risks related to the clearing of OTC derivatives. Furthermore, trade repositories need to be designed, operated and overseen in an adequate manner, given the novelty of these infrastructures and the reliance of other market infrastructures, public authorities and market participants on the accuracy and availability of the respective data.

Two complementary strands of work are underway in these fields. First, legislation for OTC derivatives CCPs and trade repositories is being developed in several countries. And second, the international standards for financial market infrastructures are currently being reviewed by the CPSS and IOSCO. In this respect I believe that given the importance of a globally consistent framework for market infrastructures, it is critical to ensure that all relevant national and regional legislation is drafted in a sufficiently flexible way to allow for the effective accommodation of the work of standard-setters.

The ***final priority*** I would like to stress does not relate to measures directly targeting market infrastructures themselves, but is closely related to this work: the need for **improving bilateral post-trading processes in line with the requirements for market infrastructures**. It is clear that without adequate bilateral risk management and disclosure, a comprehensive mitigation of systemic risk arising in post-trading could not be achieved. Moreover, an uneven regulatory level playing field could create scope for regulatory arbitrage and provide disincentives for the use of market infrastructure.

As a concrete example for necessary regulatory attention, let me mention the risk management standards for the bilateral clearing of OTC derivatives. While – as mentioned before – in principle OTC derivatives should be centrally cleared to the extent possible, some products are not suitable for central clearing, for instance owing to insufficient product standardisation, lack of market liquidity or limited availability of robust prices. At the same time, trades that are not suitable for central clearing pose particular risk management challenges given their more bespoke and opaque nature. Therefore, in my view, capital charges and collateralisation requirements for bilaterally cleared trades must be at least as stringent as the requirements for CCPs to ensure a sufficiently robust buffer against adverse market developments, operational and counterparty risks. I welcome that banking supervisors around the world are developing strengthened frameworks in this regard, working in step with the revision of global prudential standards that is currently under development by the Basel Committee.

Conclusion

Ladies and gentlemen, allow me to conclude. The regulatory reform, the new emphasis placed on macro-prudential supervision and the measures to strengthen financial market infrastructures, are all key elements on our path towards greater financial stability and an important complement to strengthened risk management and disclosure at the level of financial institutions.

More specifically, it is now of key importance that the proposed legislation concerning the enhancement of the EU institutional framework and in particular the establishment of the ESRB will be finally agreed, so as to allow its start – as planned – by January 2011.

Given the interconnectedness of our financial institutions and financial markets it is essential that an internationally consistent framework is created, ensuring a level playing field for financial institutions. Gatherings like the one today serve as a good forum to further enhance our understanding of the issues we are facing and will thus contribute to reaching efficient and workable solutions. Therefore, I very much believe that a continuous and effective transatlantic dialogue is fundamental.

Thank you for your attention.