Jean-Claude Trichet: Keeping the momentum for financial reform

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Eurofi Financial Forum, Brussels, 29 September 2010.

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Ladies and Gentlemen,

Introduction

It is always a great pleasure for me to participate in the Eurofi events. They are excellent platforms for debate about financial services issues in Europe.

This year's forum takes place at a time of considerable progress on matters of financial regulation. The establishment of the European System of Financial Supervision (ESFS), including the European Systemic Risk Board (ESRB) and the three European Supervisory Authorities (ESAs) is a milestone. I would like to commend all of those who so actively contributed to this achievement. Europe at times advances in steps, but the new supervisory architecture is more than a step; it is a *leap* forward.

We can today look back with satisfaction on what the EU has achieved. The work of the high-level group chaired by Jacques de Larosière proved to be seminal and has now born fruit. The EU has shown itself able to accomplish a comprehensive reform of its financial supervisory framework within a respectable timescale. The new framework is an important response to the financial crisis and it also takes us forward in fostering European financial integration, a key dimension of the Single Market.

The ESRB

I will have the responsibility of chairing the ESRB, which has the mandate of mitigating EU-wide systemic risk through macro-prudential oversight.

At present, we hardly need to describe systemic risk in words: we can almost feel it. In all our economies, financial distress became so widespread that it impaired the functioning of the entire system to the point where economic growth and welfare suffered massively. This financial crisis is an overwhelming case of the materialisation of systemic risk.

The ESRB will bring together risk assessments from various angles and pay particular attention to the ways in which risks can reinforce each other in highly detrimental ways. It is therefore appropriate that the ESRB draws together the work of a broad range of EU institutions: central banks; our partners in the ESFS, including national supervisors; as well as the Commission.

The ESRB is complementary to these institutions. It does not replace any of their functions. For the European Central Bank, which has been asked to provide specific support, I would like to stress that the ESRB is a body distinct and separate from the ECB, its Governing Council and General Council. Importantly, the ESRB will not change in any way the mandate and the functioning of the ECB's statutory role, and the same holds true for all central banks in the EU.

I believe that a key strength of the new institution will lie in the diversity of its members. Each of them will bring different knowledge and expertise in the many influences on the financial system. Indeed, fruitful interaction between ESRB members will be critical to ensure an all encompassing system of macro-prudential oversight of the EU's financial system. But the task of the ESRB will be very challenging. We launch this body at a time when important

parts of the financial system are still under strain and far-reaching structural and regulatory changes are ongoing.

The ESRB's mandate is wide-ranging, covering *any* material systemic risk that threatens the stability of the EU's financial system; the system's contribution to the smooth functioning of the single market; and its sustainable contribution to economic growth. The ESRB's main tasks are threefold: to identify and prioritise systemic risks; to issue early warnings when significant systemic risks emerge; and to issue policy recommendations for remedial action in response to the risks it identifies.

The ESRB will not focus on individual institutions, individual countries or individual macroeconomic issues – rather, the institution should have a strong horizontal focus, across countries, across sectors and across the boundaries between the financial sphere and the real economy. Interlinkages and spillovers should be key terms in its analysis.

To achieve these tasks, the ESRB will draw on information from many sources, including strong analytical input from its members; intelligence gathered from financial system participants; and the data necessary to understand the nature of the intricate interlinkages that define the financial system. ESRB analysis must be broad-based covering potentially any aspect of the EU's financial system – markets, institutions and infrastructure. In particular, it should extend to those areas of activity that reside outside the usual regulatory scope, often referred to as the "shadow" system.

The ESRB does not have binding powers per se. It must convince through the quality of its work. To achieve credibility, it must ensure that warnings are well-timed and that recommendations are specific and well-targeted. To reinforce its actions, the ESRB has been given the responsibility of following up, including, where necessary, alerting the Council and the European Parliament, when it judges that compliance is less than satisfactory.

Finally the new institution is embedded with a strong sense of public accountability. Strong links between the ESRB and the Parliament in particular – parliamentary hearings and annual reports, for example – will ensure that the ESRB is held to account in pursuing its oversight responsibilities.

I am very much looking forward to the ESRB's formal launch next January and very close cooperation with all authorities concerned.

The Basel III reform package

Let me turn to "Basel III", the reform package intended to put the global financial system on a sounder footing. In my view, this achievement will be a cornerstone of the new regulatory system and I would like to take a few moments to explain its evolution.

As the banking sector figured prominently in the crisis, unsurprisingly many of the G20's action points are targeted on the sector. The Basel Committee followed up on this call for action. Last December it published its proposals on strengthening capital and liquidity management. The consultation on the proposals triggered a wide response. Almost 300 comments were received from the public. The Committee also performed a macro-economic impact assessment of the stronger capital and liquidity requirements.

Taking account of all these elements, earlier this month the Group of Governors and Heads of Supervision reached a final agreement on capital requirements and the transition to the new permanent regime.

Some commentators suggest that the agreements are too lenient while others argue that they are too tight. I do not share these views, and I would like to explain why I disagree with them and why I believe that the solution we have reached strikes the right balance.

Those who argue that the package is too lenient say that the regulators have been too soft on the banking sector, basically giving in to its intensive lobbying efforts. In this vein, they

question the prudential soundness of some of the agreed measures, for example the treatment of minority interests or certain intangibles in the capital framework, or the treatment of certain types of bonds in the liquidity framework. The implementation period for the measures is another argument advanced by the "too soft" camp.

By contrast, those who argue that the agreements are too tight, point to the risk to banks' lending activity and therefore to the recovery of the global economy. The main point to keep in mind here is that despite the implementation costs, which are of a temporary nature, the new framework will benefit the global economy by enhancing financial stability through strong global standards and by contributing to avoid the massive economic and social costs of a major bust and deep recession. The so-called Long-term Economic Impact study – which like all such studies necessarily employs a range of simplifying assumptions – suggest that a 1% lowering of the yearly probability of a major financial crisis corresponds to an annual output gain of 0.6%. Of course, these figures need to taken with a pinch of salt, but they suggest that the order of magnitude is very significant. The same study suggests that, depending on the level of capital requirement, an increase of 1% in that capital requirement has a significant impact on this probability.

From a purely conceptual perspective, there is some validity in the argument that the value of certain of the assets that I mentioned earlier can be questioned in periods of extreme stress, which would suggest their deduction from regulatory capital. But presenting this as an illustration of regulatory capture is wrong, because it ignores the fact that under the achieved consensus there is overall a very significant tightening of the prudential standards.

There are two things that are particularly remarkable: first, we have been able to reach an agreement that is truly global. It encompasses not only industrial economies but also emerging economies. As many as 27 countries are part of the GHOS, even more than in the G20. Second, the end results are tough standards. If we take into account the so-called capital conservation buffer, the required common equity has been increased from 2% to 7%, this is by a factor of 3.5. If I furthermore take into account the previous definition of capital, some institutions could present the level of common equity of only 1%. For these institutions it is a multiplication by 7 which has been agreed. This is a big step upward. And overall, I consider that our agreement strikes the right balance between the objective of strengthening the resilience of the financial sector and the need to avoid unduly severe implications for national banking systems. They are also global minimum standards and national regulators or supervisors can set tougher standards if they deem that appropriate. The transition arrangements will allow banks to meet the new standards while not endangering the progressive consolidation of the recovery.

Let me mention a distinctly European note. The new European supervisory system will not only strengthen oversight, it will also foster integration. By developing a single rule book, the European Supervisory Authorities will contribute to a level playing field in Europe. By monitoring and addressing financial stability risks, the European Systemic Risk Board might increase the confidence of market players to engage in cross-border financial activities. I also see a future role for the ESRB in relation to the Basel III measures that have a clear macro-prudential flavour, such as the countercyclical capital buffers.

Issues on the G20 agenda of financial reform

Let me turn to my last point, namely the G20 agenda as regards financial reform. Financial reform is a long and arduous process, and my main message is that we have to keep the momentum.

Allow me to single out a few key areas where it is essential to keep the momentum. One is the work on reducing the moral hazard posed by systemically important financial institutions. The crisis revealed that these institutions might be major contributors to systemic risk. The G20 therefore agreed that they should be subject to regulatory and supervisory

requirements, commensurate with the risks they pose to the financial system and the real economy. This is a very complex issue to tackle as there are many different aspects for which tools need to be developed to mitigate the risks.

First, it is essential that tools are developed which increase the shock-absorbing capacity of systemically important financial institutions and lower their contribution to systemic risk. The introduction of additional measures, for example through capital surcharges and more intrusive supervision, is presently under debate. When looking at these additional prudential requirements, it is of the utmost importance that the impact of Basel III on the banking system and the broader economy is fully taken into account.

Second, it is important that tools are developed which ensure that authorities have the appropriate mechanisms in place to resolve the failure of a systemically important financial institution in an orderly and prompt manner. We have to avoid recourse to taxpayers, as was too often the case in the crisis.

There is no silver bullet to solve the problem of "too big to fail". Instead, we need to have a combination of measures, covering the full spectrum from crisis prevention to crisis management to crisis resolution.

Another area where much progress has been achieved, but where we must remain active, is the extension of oversight to institutions and markets not sufficiently covered by regulation. In this respect I hope that rapid progress will be made with the Commission's legislative proposals on short selling and OTC derivatives, which address some important shortcomings of the current regulatory framework. We also need more work on credit rating agencies and hedge funds.

Since December 2009, credit rating agencies in the EU have been subject to mandatory registration and oversight. I very much welcome the progress made, and I am pleased that the work continues. In the US also strong orientation has been adopted. We have to understand better the problem of adverse incentives arising from the over-reliance of investors and regulators on external ratings. The crisis revealed that even sophisticated investors and banks, supposed experts in assessing financial risks, too, often took the short-cut of outsourcing their risk-assessments to credit rating agencies. The regulatory endorsement of external ratings, as in the capital framework, played an important role in this failing.

On alternative investment vehicles, the G20 has called for greater oversight and in a number of jurisdictions, including the EU and the US, regulatory measures are under discussion. In this domain, too, I would call for a true level playing field at the global level and, in particular, a full convergence of the concept of oversight on both sides of the Atlantic. As envisaged in the US and in Europe, aside from ensuring proper management of alternative investment vehicles, it is important to ensure appropriate and timely reporting to authorities on investment activities so as to control systemic risk.

Concluding remarks

Let me conclude with a few remarks on what I believe is essential to achieve effective reform of financial regulation – and why it is essential to keep the momentum.

Effective financial reform needs *perseverance*. Achieving reform is complicated; there are many stakeholders, many legal issues and many international linkages. Reform should result in policies that are sound, effective and convergent across countries. Thus dialogue and coordination at a global level are essential.

Effective financial reform also needs strong *determination*. Authorities avoided a collapse of the financial system only because they were able to take decisions with great rapidity and boldness that were not listed in any text books. I will not insist on what the central banks did. It is very well-known. Let me remind us that the executive branches and Parliaments

decided to support the financial sector with a total amount of tax payer risk representing 27% of GDP – the same percentage on both sides of the Atlantic. This gigantic support permitted to avoid a depression. It did not permit to avoid the deepest recession in the advanced economies since WWII. Our strong determination to make the financial system much more resilient, and much less fragile, is two-fold. First, we must avoid in the future, as much as possible, the immense cost in terms of long-term economic growth of such a financial crisis. And second, if we had again, by misfortune, to cope with the same acute challenge, I am convinced that this time we would not obtain from our political democracies the same gigantic effort. Then a depression would be unavoidable.

This is why my colleagues and I are calling for perseverance and for resolve in financial reform. Our economic environment remains very demanding. This is no time for complacency. It is a time to remain alert, vigilant and inflexibly determined.

I thank you for your attention.