José Manuel González-Páramo: The European experience on macro-prudential regulation

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the I Jornada Financiera Banco Central de Bolivia, La Paz, 29 September 2010.

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I. Introduction

It is a great pleasure for me to be today in La Paz to participate in this important event organised by Banco Central de Bolivia. In the course of my presentation I will try to illustrate our approach to the concept of macro-prudential regulation and oversight, a new policy area where central banks are expected to play an important role.

My remarks are organised in three main parts. I will start by justifying the need to develop a macro-prudential policy framework. I will then move on to reflect on what we mean by macro-prudential oversight. Finally, I will elaborate more in detail on the establishment of the ESRB as part of the reform of the EU supervisory framework, and briefly touch upon other reform initiatives in Europe.

II. Why we need to develop a macro-prudential policy framework?

The global financial crisis has unearthed fragilities in a range of policy areas which have prompted a careful review of main policy objectives and instruments. This applies to the field of micro-prudential regulation and supervision, which failed to ensure that financial institutions had sufficient capital and liquidity to cope with the financial shock.

It also applies to the field of tax policy, in both financial and non-financial sectors of the economy, which might also have contributed to the build up of imbalances and financial vulnerabilities that later on worked as amplifiers of the financial strains.

Monetary policy, and the extent to which policy interest rates could be used to “lean against the wind” of financial market excesses in an effective manner, which is consistent with the preservation of price stability over a longer term horizon, has also been under debate.

But the area which has been under the spotlight, as the financial crisis unfolded, has been the one of macro-prudential policy.

The global financial crisis has disclosed 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, namely in the form of financial imbalances. And it has illustrated the amplitude of the consequences of the adverse feedback loop between the financial system and the real economy. In a nutshell, it has shown the potential devastating effects of systemic risks materialising in various forms.

While a range of risks and vulnerabilities were identified in the run-up to the crisis, the translation of these risk assessments into policy action was generally missing. Macro-prudential policy aims at filling this gap. Financial stability analysis, regularly conducted by a number of central banks including the European Central Bank (ECB) and other institutions (such as the IMF and the Financial Stability Board (FSB)) , aims at detecting sources of risk and vulnerability, assessing the overall resilience of the system, and its aggregate ability to withstand shocks. Macro-prudential policy adds the policy component to this oversight function.

In broad terms, policy-makers tend to agree that the objective of macro-prudential policy is to limit systemic risk, so as to minimise the costs that financial instability can impose on the overall economy. It is important to underline that macro-prudential policy is preventative in its orientation. It should not be confounded with crisis management policy, which is about the resolution of financial crisis once systemic risks have materialised. It aims at containing systemic risk by strengthening the financial system against shocks and at addressing sources of risk and vulnerability as soon as these are perceived as potentially systemic.

III. What is macro-prudential oversight?

Let me know drill down on what we mean by macro-prudential oversight and the way in which it can be made operational.

The crisis has revealed the fundamental importance of systemic risk. The purpose of macro-prudential oversight is to identify sources of systemic risk and promote remedial action. As such, a good understanding of systemic risk and its forms is at the core of macro-prudential analysis supporting policy decisions.

Regarding the various sources of risk regularly monitored by national bodies with responsibility for safeguarding financial stability, the surprise factor was perhaps the form via which systemic risk could be triggered by the collective behaviour of financial institutions and the ways in which they interact in national and international 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.

Macro-prudential analysis has two main focuses: (i) risk surveillance with the view to detect sources of risk or vulnerability within and outside the financial system, and (ii) risk assessment aiming at evaluating the potential severity of the identified risks.

Risk surveillance should aim at leaving “no stone unturned” in reviewing potential vulnerabilities and risks to the stability of the financial system. It relies on the continuous and rigorous monitoring of financial markets, financial institutions and the economy at large, with the goal of detecting potential vulnerabilities. It is important at this initial stage to cast the net as wide as possible to ensure that no risk is missed or overlooked. Early warning indicators and a broad range of financial stability indicators can also be useful in this analysis. A solid statistical information-base and market intelligence efforts are also of the essence in the risk identification process with the view to support.

The second component of the analysis – risk assessment – aims at evaluating the potential impact or severity of the risks identified, should these crystallize, as well characterising the ability of the financial system to absorb the shocks. Both the likelihood, the probability of a risk scenario, and the severity of a specific risk, need to be considered in an overall assessment. Macro stress-testing models are essential tools to assess the resilience of the financial system to risks identified in the surveillance process.

This approach might sound mechanistic but the analysis can clearly not be fully technical. Both rigorous quantitative-based risk analysis and expert judgement should be seen as input to inform decisions of policy makers on how to address the risks identified as material.

When it comes to macro-prudential policy to mitigate the risks to financial stability, a key part of developing macro-prudential instruments relies on the adaptation of existing micro-prudential tools, such as prudential standards (relating to capital requirements, liquidity buffers) and limits on activities that increase systemic vulnerabilities and risks.

In addressing the development of financial imbalances overtime, these standards and limits might need to be varied, or adjusted in a countercyclical manner, as proposed under the new Basel III regime in terms of regulatory tools addressing macro-prudential objectives. In this context, policy instruments would need to be adjusted dynamically in response to changing assessments of financial risks. Policy instruments could aim at affecting directly financial firms' balance sheets or at affecting them via indirect channels, such as conditioning the demand for credit by households or the corporate sector. Setting limits on loan-to-value ratios or adjusting collateral rules to secured lending could be some examples of measures that can effectively constrain the demand for housing credit.

The macro-prudential policy tool-kit also includes instruments that target components of the financial system other than financial institutions. Macro-prudential policy instruments could include measures addressing vulnerabilities stemming from financial markets – e.g. measures relating to securities markets or funding instruments such as margins and haircuts on unsecured lending. They could also comprise measures addressing market infrastructure vulnerabilities, such as encouraging a wider use of central counterparty (CCP) clearing houses for over-the-counter (OTC) derivatives trading and making CCPs comply with sound prudential standards.

More broadly, macro-prudential policy tools could address financial imbalances directly and need to liaise with other policy areas, should the sources of those imbalances not lie within the financial system.

Being a new policy area, progress needs to be made on a number of fronts before the implementation of macro-prudential policy can take place in earnest, at the national or the supra-national level. A number of specific issues need special consideration in this policy field, and responses to some of the issues will indicate that our understanding of macro-prudential policy is maturing. Let me mention in particular the following:

1. More thinking needs to go into defining the macro-prudential policy objective itself. On the one hand, aiming at containing systemic risk might be phrased in too vague terms; on the other hand, the specification of explicit (quantitative) targets might be inappropriate. Some experiences in introducing prudential policy instruments in the past seem to suggest that while these were congruent with micro-prudential policy objectives, the macro-prudential dimension may be missing in their design or calibration.

2. Further consideration also needs to be given to enhancing the understanding of macro-prudential policy transmission channels. The task of understanding transmission channels and assessing the potential impact of measures poses a number of challenges. For instance, it needs to take account of substitutability and competition between institution and market-based sources of credit. As such, the choice of the appropriate policy instruments may depend on country-specific factors such as the structure and features of the financial system. A better understanding of the transmission channels of macro prudential policy is critical, also on account of possible interaction with other policy areas, in particular with monetary policy.

3. Consideration also needs to be given to the potential for regulatory arbitrage. Pursuing macro-prudential policy action is likely to require a great degree of international coordination, in order to keep the scope for cross-border and cross-sector arbitrage contained. This aspect is particularly important within the European Union (EU) which is characterised, among other things, by a high degree of policy harmonisation in the financial sector.

4. Furthermore, given the fact that the framework for macro-prudential analysis and policy is presently only at a formative stage of development, the need for reflection on the risks of unintended consequences is key, as formulating policies that are aimed at safeguarding financial stability may create vulnerabilities further down the road.

IV. The establishment of the ESRB as part of the reform of the EU supervisory framework

One of the main lessons from the financial crisis concerns the necessity of a framework for monitoring the various sources of systemic risk and assessing their consequences for the financial system in a comprehensive and timely manner. Therefore, there is an agreement at international level about the need to strengthen the macro-prudential approach to regulation and supervision of the financial system as a whole.

So far there has not been in Europe an authority able, both from an institutional and operational point of view, to conduct a comprehensive financial stability assessment covering the whole EU financial sector. Apart from the financial stability assessment conducted by individual central banks, the only area-wide comprehensive assessment is contained in the Financial Stability Review, which is prepared by the ECB and focuses on the euro-area. Moreover, Europe has lacked a framework that could allow translating warnings about possible building up of systemic risks in certain components of the financial sector into concrete policy actions by competent supervisory and regulatory authorities to address such risks.

The need to address such gaps prompted important decisions in the EU with the objective of establishing a new framework for macro-prudential oversight at EU level.

Following last week's approval by the European Parliament of the relevant legislative proposals, this institutional lacuna will be filled at the beginning of 2011 with the establishment of the European Systemic Risk Board as a new EU body responsible for conducting macro-prudential oversight at the European level, with the conferral of specific supporting tasks on the ECB.

This is part of a broad comprehensive review of the EU institutional framework for supervision, which includes also the enhancement of micro-prudential supervision through the establishment of three European Supervisory Authorities – ESAs for the banking, securities and insurance sector respectively.

The ESRB will be chaired by the ECB President. The membership with voting rights (37) will include all the Governors of the EU central banks (27). This will ensure that the financial stability analysis of the ESRB will benefit from the macro-economic, financial and monetary expertise of the EU central banks.

The ESRB will be responsible for the macroprudential oversight of the EU financial system and will have the following main tasks: (i) the identification and prioritisation of systemic risk: (ii) the issuance of risk warning and where appropriate recommendations for remedial action; (iii) the issuance of a warning to the Council of Ministers on the existence of an emergency situation, to trigger further action from national and EU authorities. The establishment of this new body in charge of macro-prudential oversight is expected to bring significant improvements to the EU institutional framework for financial stability.

The participation of the European Supervisory Authorities (with voting rights) and all the EU national supervisory authorities (without voting rights) will allow enhancing the capacity of the ESRB to identify systemic risks and to define areas for recommendations for policy action. Indeed, it is expected that the recommendations of the ESRB would primarily concern the supervisory and regulatory field.

It is important to note that macro-prudential oversight should not be regarded as a substitute for the responsibilities of other authorities, namely supervisors. It should instead facilitate and complement where required the conduct of micro-prudential supervision by the competent authorities.

The effectiveness of the ESRB warnings and recommendations will rely on their quality, the act or explain mechanism between the ESRB and the addressees, the possibility of the ESRB to publish its warnings and recommendations, and also the possible role of the

Council of Ministers and the European Supervisory Authorities in supporting the implementation of the warnings and recommendations.

The combination of these elements should provide an adequate framework of incentives and mechanisms, which will greatly benefit the compliance with risk warnings and recommendations. In this context, it has been considered not necessary to provide a legally-binding nature to the ESRB risk warnings and recommendations, as this would lead to a certain overlap of responsibilities and tasks, particularly with micro-prudential supervisors.

The ECB will provide the secretariat and analytical, statistical, administrative and logistical support to the ESRB. As the ESRB will start to operate from 1st January 2011, we are intensifying the work needed for the definition of the activities that will underpin the ESRB analysis. This includes several strands of work. First, we have started to identify the analytical tools and methodologies that will support the identification and surveillance of systemic risk. This is quite a challenge in itself, as this is a new field in which further research is needed. Second, the risk assessment analysis will have to be supported by adequate information, to be provided by central banks and by supervisory authorities. This will include information both at aggregate level and, when necessary, related to individual institutions. The latter will be gathered through the European Supervisory Authorities. In particular, the ESRB may request information from the ESAs in summary or collective form, such that individual financial institutions cannot be identified. The ESRB may also address a reasoned request to such Authorities to provide data that are not in summary or collective form when the latter are not sufficient.

In fact, the establishment of a framework for efficient cooperation between the ESRB and the European Supervisory Authorities is of utmost importance for the successful pursuance of the tasks assigned to the ESRB. This is recognised by the legislation that provides a duty of cooperation and reciprocal exchange of information between the ESRB and the ESAs. In this context, the ECB and the 3 Level 3 Committees, predecessors of the ESAs, are proceeding in a dialogue on issues of common interest.

V. Concluding remarks

Let me conclude. The ESRB will have a challenging task considering the high level of expectations about its impact as well as the difficulties surrounding the area of financial stability which I mentioned earlier.

The success of the ESRB will also depend on the commitment of all stakeholders to contribute effectively to its mission. The ECB, on its part, is fully committed to ensure all the necessary support to allow the ESRB to fulfil the important responsibilities assigned to it by the Member States.

The ECB is committed to continue to invest on its analytical capabilities so as to enhance risk surveillance processes and produce high quality risk assessments with a view to inform ESRB decisions. It is also committed to devote efforts to develop a coherent macro-prudential policy framework, thereby contributing to the efforts being done at the global level in this domain, also well reflected in this conference.

Having said this, let me recall that the most important contribution that a central bank can provide to the maintenance of financial stability is to preserve price stability. Maintaining price stability has been, and will continue to be, the primary mandate of the European Central Bank, and it will not be affected at all by the assignment of new responsibilities in the macroprudential area.