

Lorenzo Bini Smaghi: Monetary union, regulation and supervision

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the 9th Annual European Financial Services Conference “Taking Stock of Reform: Fragmentation or Convergence?”, Brussels, 10 February 2011.

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Introduction

The title of this session is “Assessing the EU’s re-regulation effort”. To be clear from the outset, we are striving not simply for *re*-regulation, but for *better* regulation. What constitutes “*better*”? In my remarks this morning, I will offer a central banker’s view of where we should be heading in this domain – and of what work still needs to be done.

As recent events have shown, the financial crisis has complicated the implementation of monetary policy, in particular by creating instability in the transmission mechanism. And, within a monetary union, differences between member countries – either created by the financial turmoil or exacerbated by it – have added to the uncertainty and complexity.

During the crisis, the ECB has implemented a set of non-standard measures to address such concerns. We consider that these measures have been successful in ensuring that monetary policy remains effective. Another important factor throughout the crisis has been the firm anchoring of inflation expectations, which strengthened our stance against deflationary pressures in the worst part of the crisis. Such an anchoring is the result of all the decisions, each one of them, taken during the first decade of the euro. Overall, we believe that our ability to maintain price stability remains unimpaired.

The post-crisis world will face two potentially conflicting challenges. The first one is to achieve stronger financial integration as a factor of growth. In other words, we need more “E” in EMU. Deepening financial integration is a key aspect of the economic part of EMU. Deeper cross-border banking activities, especially at the retail level, are one way of achieving this objective. Enhancing and harmonising the regulatory and supervisory framework across Europe is a crucial step towards this goal. However, greater integration may imply greater risk of contagion, as financial systems, markets and institutions become more intimately entwined. Better regulation means achieving both a more integrated European financial sector, with deeper markets and more diversified institutions *as well as* a more robust financial system. Attaining this twofold objective would allow the benefits of integration to be reaped, while managing the associated spillover risks.

More “E” in EMU

The financial and economic crisis over the last three years has exposed the main supervisory and regulatory failures both at national and global levels. In Europe, it has also revealed how financial integration has increased the likelihood, scope and pace of contagion across the European financial sector.

The institutional framework for managing the euro area economy and financial system has proved to be inadequate. To be more specific, the monetary part of EMU has worked well. Price stability – the primary objective of the single monetary policy – has been maintained, before, during and after the crisis. But the economic dimension has been insufficient. As I just said, we need more “E” in EMU, with a view to creating an economic area that is more closely, deeply and irreversibly integrated.

The origins of the recent economic crisis lay largely in the financial sector. A more resilient financial sector is key to building a euro area framework that will be more robust and effective in facing future shocks. Deepening and broadening financial integration in Europe is an essential – although neglected – component of the economic dimension of Economic and Monetary Union.

Stronger integration will not only ensure a more *efficient allocation* of resources across the EU, but also enhance the *shock-absorbing capacity* of the financial system and the economy as a whole, thanks to increased opportunities for risk-sharing, and improved market and funding liquidity. Research using data from the United States has demonstrated the important role played by financial markets and capital flows in absorbing the impact of idiosyncratic regional shocks.¹ The risk-sharing across regions resulting from an integrated financial system in the US has a far greater smoothing effect on regional consumption patterns than that achieved via explicit fiscal transfers through the federal government's budget. This shows that it is an integrated financial sector, rather than the federal budget, which plays the most important role in ensuring that regional disturbances do not disrupt the functioning of the American economy as a whole.

Research undertaken by ECB staff confirms that greater banking integration within the EU has increased consumption risk-sharing.² But there is clearly some way to go before the level of integration – and thus the extent of risk-sharing – seen in the United States is achieved.

These results have important implications for the current debate on further European integration. There is a lot of talk about the need to move towards a more integrated fiscal union and debt financing in the euro area, as a means to enhance stability. A more integrated financial market is likely to be a more efficient way to enhance euro area resilience.

Financial integration did advance rapidly after the introduction of the euro, particularly in wholesale markets. But in certain segments, markets have remained fragmented along national lines – not least retail banking. This is a politically sensitive sector, due to concerns about consumer protection and the financing of small businesses. But when retail banking markets are fragmented, governments are more likely to resort to “national solutions” in the face of a financial crisis – possibly in an uncoordinated fashion. Experience shows a piecemeal approach can be very disruptive to financial stability and monetary transmission. For example, we have seen the externalities created by the Irish government's decision to guarantee all Irish bank liabilities in the immediate aftermath of Lehman's failure in 2008. We are still dealing with the consequences of those decisions.

To ensure that the benefits of greater financial integration more than outweigh the risks – including that of a more concentrated banking system – the EU regulatory and supervisory framework needs to be enhanced and harmonised, taking the necessary area-wide perspective and thereby recognising and internalising the cross-border externalities.

One objection to a more integrated banking system in Europe is the role of national budgets in crisis resolution. As long as budgets remain national – so goes the argument – crisis resolution has to remain national, and so does supervision. The crisis has shown that bank resolution and restructuring are more complicated for cross-border institutions, given that any

¹ Asdrubali, P., B.E. Sørensen, and O. Yosha (1996). “Channels of interstate risk sharing: United States 1963–90,” *Quarterly Journal of Economics* 111, pp. 1081–1110.

² Kalemli-Ozcan, S., S. Manganelli, E. Papaioannou and J-L. Peydró (2008). “Financial integration, macroeconomic volatility and risk sharing – The role of the monetary union,” in B. Maćkowiak, F.P. Mongelli, G. Noblet and F. Smets (eds.) *The euro at ten: Lessons and challenges*, Frankfurt: European Central Bank.

fiscal costs have to be distributed across several host sovereigns. As Charles Goodhart has said, "...cross-border banks are international in life, but national in death".³

As I see it, enhanced financial integration in the euro area does not necessarily imply a need for greater fiscal union – if that is understood as a pooling of tax revenues, harmonisation of tax rates or issuance of a common bond. Instead, we must develop the capacity at the area-wide level to address *specific* financial tensions that threaten to spill over to the area as a whole, minimising disruptions to market integration and supporting the transmission of monetary policy.

The recent crisis – and, in particular, developments in Ireland – have demonstrated that, despite the imperfect integration of the European financial system, very strong cross-border contagion takes place within the financial sector. The instruments available at present to block this contagion are not efficient and have side-effects. In practice, much of the burden to contain contagion has fallen on central banks. This is neither desirable nor appropriate.

In my view, the European authorities need to develop a capacity to conduct a "surgical strike" on problematic financial institutions or market segments in the event of a financial crisis. Through such actions, the area-wide externalities created by specific problems can be contained. In practice, this means ensuring that programmes such as the European Financial Stability Facility (EFSF) or the European Financial Stabilisation Mechanism (EFSM) – and their envisaged permanent successors – are given sufficient financial resources *and* the required flexibility by the Member States to act as necessary to support financial stability. To do so, these bodies may also need to be able to support the recapitalisation of an ailing banking system, if its weakness threatens the stability of the area as a whole. All this of course comes with strict conditionality in the context of an overall EU/IMF programme.

This has been the case in both the Greek and Irish programmes, in which funds are dedicated to the recapitalisation of the weak banks. A more systematic approach should be pursued, making it easier for countries to implement such a scheme.

Developing an enhanced and harmonised regulatory and supervisory framework

The ECB has a keen interest in ensuring that the regulatory and supervisory structure, at both national and EU level, provides all players with incentives to avoid excessive risk-taking that could lead to destabilising the financial system. In addition, consistent rules and convergent supervisory practices are essential to the creation of a level playing field and avoidance of competitive distortions, which would otherwise hinder financial integration within the euro area.

The financial crisis has prompted a significant development of the regulatory and supervisory framework. Under the auspices of the G20, a remarkable amount of work has been done to mend the regulatory shortcomings revealed by the crisis at global and European level. A key element in strengthening the resilience of the financial system has been the adoption of the new Basel III framework. Concrete efforts have also been made to reinforce the supervisory framework, with greater emphasis placed on monitoring and assessing macro-prudential risks. The powers and tools of micro-prudential supervisors have also been enhanced. Other important regulatory initiatives, notably work on systemically important financial institutions, shadow banking, crisis management and resolution frameworks, are under way.

In Europe many initiatives have been or are being taken to strengthen the regulatory and supervisory framework. Amendments to the Capital Requirements Directive (CRD) have been made to correct the adverse incentives relating to securitisation and remuneration. A further review of the CRD is under way, aligning the European regulatory framework with the

³ Goodhart, C.A.E. (2009). "Procyclicality and financial regulation," Banco de España, *Estabilidad Financiera* 16, p. 16.

Basel III framework, which is expected to improve the resilience and stability of the banking system by enhancing the quality and quantity of capital and introducing leverage and liquidity requirements. Other important initiatives have also been taken or are under way to improve and extend the scope of regulation. Examples include the regulation of hedge funds through the adoption of the Alternative Investment Fund Managers Directive and credit rating agencies, and the upcoming review of the Markets in Financial Instruments Directive (MiFID).

In addition to the ongoing initiatives to reinforce the regulatory framework, the supervisory framework in Europe has also been enhanced through the establishment of the European Systemic Risk Board (ESRB) and the three European Supervisory Authorities (ESAs). These authorities should help to strengthen the oversight of risks. The risk warnings and recommendations to be issued by the ESRB should become a powerful tool to identify significant risks in the financial system. And the powers of the three ESAs – notably their mediation and coordination powers, their envisaged role in emergency situations and, in particular, their mandate to create an EU rule book through the issuance of binding technical standards – should further harmonise the regulatory and supervisory framework within the EU.

Even though the framework has been substantially enhanced, challenges remain. Whether the framework will reach its full potential depends on many factors.

First, it is important that the new authorities are empowered to act decisively and swiftly. Rapid decision-making as well as the independence of regulatory authorities is essential to safeguard financial stability. In this context let me mention that in the US the Financial Stability Oversight Council and the Federal Deposit Insurance Corporation have been granted more regulatory powers than their counterparts in the EU, although the effectiveness of those powers will ultimately depend on the way they are applied.

Second, it is important that within our relatively complex institutional framework, the ESRB, the three European Supervisory Authorities and the national authorities collaborate effectively. Information-sharing is key. It has been insufficient in the past. Will it change in the future?

Third, the creation of an EU rule book is, of itself, not enough. Only when its implementation is harmonised can such a rule book facilitate cross-border activities, and thus contribute to a more integrated financial system. The ESAs have an important role here to ensure that the rule book is implemented in a consistent way also through their coordination of the activity in colleges of supervisors. In addition, the ESAs, crucially, have to ensure that the EU-wide stress tests are conducted in a uniform way. We have seen from experience that the credibility of the results of the EU-wide stress tests depends on whether they are conducted with sufficient rigour in all the countries. Lack of rigour in one country can undermine the credibility of all.

All these elements of the new European supervisory framework are expected to address the challenges related to an integrated area such as the EU. However, in the euro area the very existence of the single currency amplifies the interconnectedness between countries and financial systems and thus the potential for contagion in stress situations. The new EU supervisory framework must therefore be capable of addressing this specificity of the euro area through tailored coordinated actions.

Financial stability and monetary policy

Within this changing institutional landscape, close collaboration is required between central bankers, regulators and supervisors, given the intimate connection between monetary policy and financial stability. The European arrangements, with the close links they have established between the ECB and the ESRB, recognise this need, while retaining distinct mandates and maintaining a clear division of responsibility.

Recent events have amply demonstrated how financial crises influence macroeconomic prospects, the outlook for price stability and thus the appropriate setting of the monetary policy stance. At the same time, we have seen how monetary policy measures – of both standard and non-standard varieties – can support the functioning and stability of financial institutions and markets. After all, central banks are the ultimate providers of liquidity, and thus have a pivotal role to play in any financial turmoil or panic.

The interactions between monetary policy and financial stability are complex. They need to be managed carefully, avoiding any confusion of mandates and responsibilities. In particular, we need to avoid moral hazard. Liquidity support provided to banks that face funding difficulties cannot delay the necessary fundamental restructuring of such institutions.

Recent experience confirms my view that central banks must be closely involved in addressing financial tensions, cooperating closely with supervisory bodies in supporting financial stability, even while recognising the primacy of their own price stability mandate.

Concluding remarks

To sum up, deeper financial integration within Europe is critical in making the economic dimension of Economic and Monetary Union function better. It will not only offer direct gains in terms of allocative efficiency, but also make monetary policy transmission more effective and robust, thereby supporting the achievement of our primary objective of price stability, as well as wider macroeconomic stability. Greater cross-border banking activity, especially at the retail level, has an important role to play in this regard.

These conclusions are consistent with the main message of the Lamfalussy report, published as far back as 2001.⁴ This report argued that progress with financial integration in the EU should be regularly reassessed and, if necessary, initiatives taken to further deepen and accelerate the integration process.

The recent crisis has demonstrated that the European financial system was insufficiently robust. Further measures to deepen integration and bolster stability are required. Looking forward, we have to identify any remaining weaknesses and seek to address them.

Until now, it has generally been argued that the main responsibility for financial supervision has to remain at national level. The consequences of failures in supervision ultimately fall on the taxpayers of the country where the bank resides. To align incentives and ensure appropriate accountability, nationally defined tax bases imply nationally defined supervisory institutions.

However, the crisis has demonstrated that the implications of supervisory failures extend well beyond national boundaries. First, cross-border contagion has been magnified by externalities and spillovers arising from greater area-wide financial integration. Second, experience has shown that, within a more integrated market, greater specialisation may imply that financial systems in one country outgrow the capacity of national taxpayers to support them.

The implications of this experience are profound. As I have argued, they point to the need for a much greater euro area and EU perspective in the supervisory and regulatory framework. While progress has been made in this domain, much remains to be done.

Thank you for your attention.

⁴ Lamfalussy, A. et al. (2001). Final report of the Committee of wise men on the regulation of European securities markets, http://ec.europa.eu/internal_market/securities/docs/lamfalussy/wisemen/final-report-wise-men_en.pdf