

## **Lorenzo Bini Smaghi: Banking supervision and corporate governance in the European architecture**

Speech by Mr Lorenzo Bini Smaghi, Member of the Executive Board of the European Central Bank, at the closing seminar “Banking supervision and internal audit as contributors to sound corporate governance and financial stability”, Moscow, 30 March 2011.

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### **Introduction**

Ladies and Gentlemen,

It is a great pleasure to speak to you on this occasion here in Moscow. The Cooperation Programme that ends today has been very successful in two important fields for central banks: banking supervision and internal audit. Looking back at this venture, we can see that three unusual, eventful years have passed since 1 April 2008. The macroeconomic, financial, and also political environments in the euro area and around the globe have been in a state of flux, and sometimes in turmoil. Likewise we all have been moved and saddened by natural disasters and human error, by acts of war and acts of terror.

At the same time, these three years have also seen remarkably positive events. The Central Bank of the Russian Federation celebrated its 150th anniversary last year. It steered its way successfully through the financial crisis. The Bank of Russia became a member of the Basel Committee on Banking Supervision and of the Financial Stability Board. The European Central Bank, meanwhile, marked the tenth anniversary of the euro. It became an EU institution as a result of the Treaty of Lisbon in 2009. And the EU Commission here in Russia has also had a change of status: it is now the EU Delegation to the Russian Federation and is part of the European External Action Service.

As I just said, banking supervision and internal audit have been the focus of work here these past three years. A three-way partnership was formed, consisting of the EU Delegation, the Bank of Russia and the Eurosystem. The Eurosystem acted through the ECB and eight national central banks: the Deutsche Bundesbank, Banque de France, Banca d'Italia, Banco de España, De Nederlandsche Bank, Oesterreichische Nationalbank, Bank of Greece and Suomen Pankki/Finlands Bank.

### **Central bank cooperation in challenging times calls for resolute action**

The coming years are likely to be just as challenging as recent years. Central banks will be required to act as anchors of monetary and financial stability in a rapidly changing world.

The Eurosystem central banks are cooperating in banking supervision, financial stability, internal audit and in many other fields. In addition to the Programme here in Russia, a Eurosystem programme on Basel II is under way involving the Central Bank of Egypt. A crisis response package covering banking supervision and financial crisis management is being conducted with south-eastern European countries. And technical assistance is being given to a number of would-be EU members.

### **Europe strengthens its institutional framework for financial stability**

Generally, Europe has responded to the challenges of the past few years in a structured and thoughtful way. The creation of the European Systemic Risk Board (ESRB) broadens the scope of cooperation and institutional awareness in respect of macroprudential oversight. The ECB is the supporting institution and provides, *inter alia*, analytical and statistical inputs to the ESRB structures. The Risk Board enables European regulators and supervisors to

complement the *microprudential* perspective with a systematic monitoring and assessment of potential dangers to the stability of the system *as a whole*. The discipline of macroprudential supervision combines the information and assessments obtained via microprudential supervision with macroeconomic and monetary insights. We expect macroprudential measures, such as countercyclical provisioning, to mitigate systemic risks. We also expect the findings of macroprudential oversight to feed into the microprudential work that alerts supervisors and the wider world to macroeconomic risks.

Besides setting up the ESRB, on 1 January this year, three European Supervisory Authorities (ESAs) came into being: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities and Markets Authority. We expect that these new institutions will sustainably enhance microprudential supervision in Europe.

Currently, the EU and euro area financial system continue to face several important risks. The main source of concern is the interplay between fiscal imbalances, downside risks to economic growth and bank funding vulnerabilities. Although this interplay is limited to a small number of euro area countries, with a relatively small share of total EU and euro area GDP, potential contagion to other EU or euro area countries is not insignificant. In this respect, let me state how surprised I am to see how quickly some of the lessons of the crisis are being forgotten. One of the lessons is the need to assess risk in a systemic way, not only at the micro level. There can be no systemic assessment without taking contagion into account, across instruments, across markets and across countries. The sub-prime crisis or the collapse of Lehman have clearly shown how devastating contagion can be! It is thus all the more surprising to see how in the current environment some policy makers, academics or editorialists totally ignore the systemic dimension of financial markets in their proposals for very specific issues like for instance bank debt. Thinking that a specific category of assets – such as senior bank bonds – can be treated in a specific way without immediately affecting all other assets, or that certain banks can be treated in a way that does not impact the whole system, not only within a country but also cross border is a testimony of short memory. The same applies for sovereign debt instruments.

The risks related to the re-emergence of global imbalances and any disorderly unwinding are also considerable. Moreover, the catastrophe in Japan and tensions in the Middle East show us that risks of various sorts (natural, geopolitical, etc...) are never far away.

In addition, a new round of stress tests is being carried out between March and June this year, with the final set of results to be published in June. There have been many comments and discussions about these stress tests, often without sufficient information. There is no doubt that the success of these tests depends on their full understanding on the parts of market participants. It is thus essential that supervisory authorities coordinate closely within the EBA their communication strategy. It's no time for cacophony, nor for national authorities to engage in a beauty contest.

Compared to the previous round, the underlying scenarios are considerably more adverse, in particular in terms of overall decline in GDP which encompasses the sum of all the parameter changes (interest rates, haircuts, probability of default, ...). The probability of the scenario is, over a two year horizon, much lower, especially for 2011 where it is 1%, instead of 7% last year. Moreover, national supervisors and banks will have less discretion in conducting the tests. This time the EBA will be giving direct guidance regarding the definition and projections of pre-provision operating profits, including the increased cost of funding. The thresholds in the stress tests will be set at levels which are substantially higher than the minimum solvency requirements.

## **Banking regulation is becoming stricter**

In a broader sense, Europe has been actively contributing to stronger prudential supervision, notably banking supervision. At both global and national levels, there has been a marked tightening of banking and prudential rules. Work on corporate governance and internal audit has progressed too.

In light of the financial crisis experienced in advanced economies, it could fairly be asked whether the rules are to be blamed or the way in which they were applied. The answer to this question is pertinent also for this cooperation Programme.

In fact, it was decided that work foreseen in the Programme concerning the implementation of the Basel II framework should continue. Basel II focuses on risk-based supervision. It requires banks to operate a structured risk management. The internal capital adequacy assessment process (ICAAP) required by pillar 2 is a model for systematic strategic planning for any financial enterprise. Financial firms must have an understanding of their risk and capital situation. They are required to have a continual review of their risks, capital and business environment. I think that they will flourish only if they embrace in their corporate processes and culture the continual learning paradigm. This focus on the systematic management of a financial institution has been repeatedly stressed in both parts of the Cooperation Programme. Rightly so: the soundness of a financial firm depends on its own managers' capability to understand, measure and master the risks, and to grasp the business opportunities on the basis of a good control of the downside risks. That capability constitutes its first line of defence. Supervision can only be the second line of defence.

## **Internal audit is an essential part of corporate governance**

The internal audit part of the Cooperation Programme has focused on risk-based audit and IT audit. The audit function is oriented towards the organisation's objectives. Internal audit delivers independent views and advice on the governance of the organisation. A comprehensive and systematic view of the risks posed to the objectives and the organisation as a whole guide the auditors in the planning of their work as well as in the follow-up to their recommendations. As IT is nowadays an intrinsic part of the infrastructure as well as a critical business tool, the Programme's focus on the particular challenges of the IT audit was certainly appropriate. Overall, the Programme emphasised risk orientation rather than compliance checks, an approach that is indispensable today. Only an audit function that understands the dynamics of the changing environment and the impact of these changes on the organisation's objectives can provide the necessary reassurance to the organisation's top management. The Programme has contributed to such a risk orientation – which has meant a considerable cultural change for the audit function.

I think that risk-based audits need two key ingredients for success: firstly, chief auditors must enjoy the full trust and backing of the organisation's top management, even when they convey unpleasant or unwelcome messages. And secondly, the auditors can only do their job properly if they are empowered to act autonomously.

## **Central bank cooperation – a long-term investment that will bear fruit**

I have sought today to shed some light on the importance of various tools for the soundness of our financial systems: banking supervision, internal audit, micro and macroprudential supervision as well as audit and corporate governance. The “investment” that this Programme has made in banking supervision, as society's “systemic financial risk management”, and in internal audit, as an element to help an organisation achieve its objectives, is fully in line with this approach. I am confident that the investment will bear fruit in the years to come.

Finally, let me thank all those involved in this project – the EU Delegation, the Bank of Russia and also the colleagues from the eight national central banks and the ECB. It's the close cooperation in these uncertain times which has made this remarkable project so successful. I sense that, although we are concluding this particular venture, the challenges of the future and the very positive experience of this Programme will certainly justify new partnerships in the future. I sense that there is no shortage of interest and enthusiasm to join forces again.

Many thanks to all those who contributed.

And thank you for your attention.