José Manuel González-Páramo: The management of the banking sector and the economy – what have we learned about financial markets and regulations?

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the XXVII Reunión Círculo de Economía, Sitges, 3 June 2011.

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Ladies and Gentleman,

It is a pleasure to have the opportunity to speak at this prestigious forum today. The first round of the meetings of "Círculo de Economía" took place exactly 50 years ago (in 1961), constituting a very unique event in Spain at that time. Since then, these meetings have provided an excellent forum to exchange views and ideas on issues of European and global relevance. Today we meet at a time of multiple challenges for our world, so I am sure that inspiring discussions will take place.

For more than three years we have been focused on the challenges that the financial crisis has posed to our economies and our societies. Still, recent developments in European sovereign debt markets as well as ongoing economic difficulties in some euro area countries remind us that the crisis is not over yet. While the ECB continues to confront, in a decisive manner, the tensions in financial markets, it is also involved in the reform of the global financial system that is currently in progress.

I would like to lay out today what I believe are the core areas of the regulatory reform, detailing what has been achieved and what remains to be done.

Introduction

Let me start by saying that under the leadership of the G20, a remarkable amount of work has been done by the Financial Stability Board (FSB) and the Basel Committee regarding financial reform. In Europe, the European Commission has also adopted several new pieces of legislation and many more are underway in order to strengthen the regulatory and supervisory framework.

I believe that we can identify the following key areas of the financial reform: *First*, **strengthening the resilience of financial institutions**. This includes the introduction of the Basel III framework for banks, eliminating the too-big-to fail problem as well as ensuring adequate oversight of the shadow banking system. *Second*, **increasing transparency and mitigating the pro-cyclicality in financial markets** and finally, *third*, introducing **macro-prudential supervision**, which can be considered as the missing link in the pre-crisis era. The crisis has shown the need for a systemic perspective of the financial system that takes into account the interactions within the system as well as with the real economy.

1. Strengthening the resilience of financial institutions

Let me **first** start with ***Basel III***, which constitutes the cornerstone of regulatory reform for the banking sector. While Basel II was very much focused on a single ratio (capital to risk-weighted assets), Basel III takes a more comprehensive approach, addressing deficiencies of Basel II and further strengthening the armoury of prudential requirements. Let me highlight the main elements of the new Basel III framework:

Basel III provides for higher minimum capital requirements, a stricter definition of eligible capital and more transparency. The crisis highlighted the urgency of establishing a common definition of capital. The fact that the definition of what constituted Tier 1 capital was neither transparent nor harmonized across countries, contributed to a generalised loss of confidence in the quality of regulatory capital. In addition, it proved necessary to increase the overall level and loss-absorbing capacity of the capital held by banks.

Moreover, Basel III introduces also entirely new concepts, such as non-risk-based leverage ratios and mandatory liquidity requirements. The leverage ratio will offer a transparent measure to the market that will complement the risk-based capital calculations and introduce additional safeguards against model risk and measurement error. The new liquidity buffers will ensure, in the short term, that banks hold sufficient high quality liquid assets to withstand an acute stress. In the longer term, the buffers will increase banks' incentives to use more stable sources of funding on a structural basis.

Lastly, beyond the micro-prudential dimension of regulation – typically represented by institution-specific solvency requirements – Basel III also introduces macro-prudential elements, most prominently the capital buffer regime. This constitutes an important safeguard to protect the banking sector from periods of excessive aggregate credit growth.

Let me say that, while generally supporting the underlying objectives of the regulatory reform, the industry has been critical towards the new capital requirements. The industry is of the view that Basel III will increase costs for banks, reduce profitability, lead to credit supply restrictions and, ultimately, hurt the economy.[1] Theory and historic experience however demonstrate that those claims are partly based on misconceptions that are important to dispel. Although I will not elaborate in detail, let me highlight the following:

In the **long run**, benefits brought by the enhanced capital and liquidity regulation can be substantial. They include a reduction in the frequency of crises and hence on the expected output losses associated with systemic events. The new framework should also improve the level playing field for the international banking sector. This is expected to help financial institutions to save costs and to encourage cross-border activities. In turn, this should result in a more efficient financial sector and also bring benefits to non-financial corporations and households through higher competition and increasing availability of financial services.

In the **short term**, given that financial markets are characterized by information asymmetries and frictions, the new regulatory requirements will most likely imply some transitional costs on the economy through tighter credit conditions. Adverse effects are however expected to be moderate, notably if they are spread over a long implementation period. Estimates by the BCBS as well as by the ECB concluded that a 1 percentage point increase in the capital ratio implemented over eight years would result in a moderate cumulated reduction of GDP of around 0.15 percentage points. Indeed, the new measures will therefore only become fully effective on 1 January 2019. This long phasing-in period should provide the banking sector ample time to adjust to the new regulatory requirements and prevent disruptions in credit flows.

Looking forward, it is of the essence that Basel III is properly implemented at the global level. In addition, it is important that the proposals on the leverage ratio and liquidity risk framework are rigorously calibrated, so that any unintended consequences for individual banks, the banking sector, and financial markets can be timely addressed.

Second, it is important that work is kept apace on ***systemically important financial institutions, or so-called SIFIs***. The financial crisis has evidenced that large, complex and cross-border banks pose exceptionally high risks on the financial system and society at large. By virtue of their "too big to fail" status, these financial institutions assume a systemic dimension which, in the event of a crisis, results in large wealth transfers from taxpayers to the banking system.

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[1] Institute of International Finance (2010): "Net Cumulative Economic Impact of Banking Sector Regulation: Some new Perspectives", October 11, 2010.

Against this background, the G20 has endorsed an ambitious program that aims at reducing the probability of default of a SIFI. As a key priority, it has been agreed that SIFIs should have higher loss absorbency capital beyond Basel III standards. The purpose of these requirements is threefold: first, to increase SIFIs resilience to adverse shocks; second, to internalise the costs of distress they impose on the financial system; and third, to restore proper incentives with respect to their risk-taking.

Let me also highlight that a key element of the SIFI policy framework is to develop strengthened resolution frameworks to ensure that all financial institutions can be resolved safely and quickly, without destabilising the financial system and exposing the taxpayer to the risk of loss.

The FSB is focusing on the identification of the key elements of effective resolution regimes, which will identify the essential features that national resolution regimes for financial institutions, including non-bank financial institutions, should have. Let me mention that the EU is actively participating in the ongoing work and is also taking these global initiatives into account in the design of the European framework.

Third, another important area where work needs to progress relates to the so-called ***"shadow banking system"***. The financial crisis evidenced that systemically important pockets developed in the financial system without any regulatory oversight. A better understanding of the interconnections between regulated and unregulated entities is needed. Moreover, it is important to bear in mind that the introduction of more stringent capital requirements for credit institutions may provide further incentives to shift activities outside the regulatory perimeter.

For this reason, the regulatory reform should not only focus on regulated banks. It should instead be based on a comprehensive system that extends in a proportional way to all actors, intermediaries, markets and activities that embed potential systemic risk.[2] In this area the identification of data gaps and putting in place an effective monitoring framework as well as reinforce the accounting rules on consolidation internationally are key.

2. Increasing transparency and mitigating the pro-cyclicality in financial markets

I would now like to touch upon the measures taken with regard to the regulation of financial markets. Here, reform must ensure greater transparency for the various market segments and products, sufficient competition in all markets, and attenuate as much as possible the pro-cyclicality that derives from information asymmetries, structural features such as ratings, market phenomena such as herding and short selling practices. In this speech I will focus in particular on improvements in the regulation of OTC markets.

Private financial markets cannot function properly unless there is enough information and reporting both to market participants and to relevant regulators and supervisors. The financial crisis evidenced the increasing opaqueness of the financial sector and the resulting counterparty risk externality. Regulatory initiatives that are underway to remedy these issues are therefore of utmost importance.

Let me begin by highlighting the importance of ***establishing an appropriate regulatory framework for OTC derivatives***. OTC derivatives markets have grown exponentially in size over the past decade and they are closely related to the underlying cash, bond and equity markets. However, the development of risk management practices for these products has not kept pace with their growing use and systemic importance as the financial crisis demonstrated in a number of instances, such as the Lehman default and the near-defaults of AIG and Bear Stearns.

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2 Acharaya and Richardson (2009): "Restoring Financial Stability", Wiley Finance.

Against this background, regulators are currently working to address three issues in particular. *First*, to foster market transparency through reporting of all transactions to trade repositories, which in turn will disseminate the related data to regulators and the public in line with their information needs. *Second*, to mitigate counterparty risks through use of central counterparties for sufficiently standardised and liquid products. *Third*, to ensure the safety and soundness of OTC derivatives central counterparties and trade repositories, given the concentration of risks in these new infrastructures.

- In the EU, the forthcoming EU Regulation for OTC derivatives, central counterparties and trade repositories is the key initiative to implement these objectives. However, given the global nature of OTC derivatives markets, the EU framework will only be effective if it is consistent with legislative initiatives in other jurisdictions and cross-border cooperation among authorities in ensured. To this end, the new EU rules should be fully in line with the global supervisory and oversight standards for financial market infrastructures that are currently being reviewed by the Committee on Payment and Settlement Systems (CPSS) and the Technical Committee of the International Organization of Securities Commission (IOSCO). The CPSS and IOSCO issued a consultative report entitled “Principles for financial market infrastructures” last March and their guidance is expected to be finalised in early 2012.

Another important initiative relates to the ***enhanced oversight of Credit Rating Agencies (CRA’s) and the need to reduce the mechanistic reliance on external ratings***. Ratings are crucial to investors’ decisions and are deeply embedded in the regulatory architecture. It is therefore essential that ratings that are independent, objective and of the highest possible quality, as shortcomings in rating activity can erode market confidence and adversely affect financial stability. Moreover, the crisis has evidenced that ratings downgrades have contributed to the pro-cyclicality of the financial sector.

In the EU, the Credit Rating Agencies Regulation was adopted in 2009 and regulators and credit rating agencies are currently preparing for implementation of these rules. In our Opinion, the ECB supported the need to reduce reliance on external credit ratings. This could be pursued via two main avenues: *first*, firms should be required to undertake their own due diligence and internal credit risk assessment. *Second*, supervisors should focus on developing rules to appropriately combine internally developed credit judgment and external input with varying weights depending on the specific characteristics of the credit exposures. In addition, we fully support initiatives by the European Commission to enhance transparency and disclosure of the rating process and in launching a debate on enhancing competition.

3. Introducing macro-prudential supervision

The aim of macro-prudential supervision is to mitigate and prevent systemic risks to financial stability on the basis of identified vulnerabilities and systemic risk assessments. The financial sector regulations before the crisis very much focused on limiting each institution’s risk seen in isolation rather than on aggregate or systemic risk. As a result, financial institutions were encouraged to pass their risks around the system and to unregulated entities, increasing the vulnerability of the system to large macroeconomic shocks. In Europe, in particular, the crisis highlighted the absence of a proper framework for macro-prudential oversight.

Against this background, a new European System of Financial Supervision entered into force on 1 January 2011. Alongside with national supervisory authorities, who will continue to be responsible for day-to-day supervision of firms, three European Supervisory Authorities have been created – respectively for the banking, insurance and securities markets. A new body, the European Systemic Risk Board (ESRB) has become responsible for macro-prudential oversight of the EU financial system. The primary task of this new body is to monitor the EU’s financial system as a whole identifying sources of systemic risk, and to issue risk warnings and policy recommendations addressing systemic risks. The ECB President will chair the

ESRB and the ECB will provide analytical, statistical and logistical support to the ESRB, as well as its Secretariat.

The establishment of the ESRB is a key milestone in how Europe deals preventively with systemic risks. It forms part of wider initiatives across the world, including in the US with the establishment of the Financial Stability Oversight Council.

The European System of Financial Supervision is still in the starting-up phase and it will need time to establish itself. As regards the ERSB I believe that there are three key conditions in order for it to reach its full potential. The first is the need for an adequate infrastructure to identify and analyse systemic risks, which demands state-of-the-art analytical tools. And here I believe the ECB is well-equipped to support the ESRB with its analytical expertise. The second, given the non-binding nature of the warnings and recommendations, is building-up a strong reputation. Indeed, credibility will be key in ensuring addressees implement the recommendations. Also here, I firmly believe that the expertise of the members sitting around the table, in particular the expertise of central banks in analysing financial stability will be crucial in successfully building up this reputation. And finally the third relates to the need to cooperate and exchange information effectively among all members of this new European System of Financial Supervision. The experience of the European System of Central Banks will also prove useful, in this context.

Conclusion

Let me conclude by mentioning that substantial progress has been achieved in key areas of regulatory reform. However, our work is not finished and there is no room for complacency.

In order for the new regulatory regime to be effective, a coherent and consistent implementation of the reforms at a global level is of paramount importance. Only then can regulatory arbitrage be prevented and a level playing field ensured. At the European level the three European Supervisory Authorities have an important task in ensuring a consistent implementation of the regulations.

We cannot forget that the financial crisis and its aftermath have been one of the most disruptive events in decades, causing massive economic and social costs. Tensions originating from a relatively small segment of the international financial market evolved into a global crisis, revealing deficiencies in the regulatory framework which must be addressed. In the aftermath of the crisis, industrialized and developing nations pledged to adopt a common approach to reinforce the resilience of the financial system and ensure its sustainable contribution to growth.

We cannot lose sight of this shared mission and responsibility. Determination and consistency in the implementation of these reforms is therefore now crucial.

I thank you for your attention.