Erkki Liikanen: The European experience – the foundation for the promotion of securities markets in Finland

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at a seminar entitled "Lessons of the financial crisis", Helsinki, 10 June 2011.

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The European experience

Ladies and gentlemen,

In Europe, the first signs of the latest financial crisis emerged in the money market. The spreads between collateralized and uncollateralized market rates started to increase rapidly. We witnessed the development of elevated financial market stress that turned out to be unprecedented in modern financial history. Liquidity was suddenly becoming a scarce and costly asset. These developments were particularly disturbing to central banks as the damaged transmission mechanism of monetary policy ruptured the steady relationship between policy and lending rates.

It was not only the pricing of the liquidity risk that had been ignored over the years preceding the crisis. Banks started to feel uncomfortable with the exposures they had been used to taking on with each other. Suddenly it was not enough to rely on close business relationships and trust.

Once banks started to hoard liquidity, it was not only an indication of scarce liquidity, but a sign of an even more fundamental problem. Counterparty risks had risen to a new level. Increases in counterparty risk were fuelled by falling asset prices – as banks saw how their own balance sheets started to deteriorate, they became worried about other banks' balance sheets being affected even more.

Also unprecedented in financial history was the speed with which counterparty risk was shifted from one country to another. The global lack of trust between banks had a major negative impact on international trade. Inventories in firms were cut to a minimum and investment plans were frozen at a record pace. Consumers increased their precautionary savings. All this caused a sharp global downturn, or a Great Recession as it is now called. In many countries this was comparable to the great depression of the 1930s.

Policy makers reacted promptly and massively to the crisis in all areas. A strong fiscal stimulus was supported globally. TTT, Timely, targeted and temporary was the often-used phrase. Monetary policy reacted aggressively in all advanced economies. Interest rates were lowered at a record pace and liquidity was pumped into to the banking systems.

As the first signs of the banking crises started to materialize, actions taken were miscellaneous, depending on the symptoms. But there was one common source of risk that had a global impact. It was related to the mortgage markets in the US. Housing loans had been originated without sufficient documentation or with overly optimistic underwriting assumptions. Then these housing loans were sold off in complex derivative securities globally. Credit rating agencies had given them high ratings. Suddenly financial institutions had highly risky positions in their balance sheets due to either a lack of diversification or to excessive leverage ratios. This risk taking was high enough to wipe out all big investment banks in the US and to cause bank failures and serious deleveraging needs in Europe.

Often these failures had an insidious reason behind them. The transparency of the banks' balance sheets had been weakened by the off-balance arrangements. This was a further reason for increased counterparty risk. Regulators and supervisors had allowed financial institutions to shift a considerable part of their activities to special purpose entities. This often happened with generous credit lines from the parent financial institutions.

When liquidity became scarce and asset prices started to fall, those credit lines turned out to be a big burden for banks' capital. Failures of the off balance sheet institutions and the resulting losses to the parent companies were the origin of serious deleveraging needs that put a burden on banks, especially in Europe, to this day.

Banks' problems, first country by country, and after Lehman, globally, forced governments to promise – implicitly or explicitly – blanket guarantees to safeguard financial institutions. For some countries and financial institutions this was a blessing, but for other countries it turned out to be a fatal kiss. During the years leading to financial crisis some countries had made a choice to centre their growth strategies around financial services. UK, Iceland, Ireland and to come extent even Sweden were examples.

The strategy worsened the downturn and increased the banks' need to deleverage further. New capital was also needed. What was not recognized were the consequences of financial crises in the situation when the size of the banking sector was huge compared to the GDP. Iceland and Ireland were leading examples, In Ireland and Iceland this strategy was also the main cause of the government debt crises that immediately followed.

There was also another route that ended in problems to banking. In Greece and Portugal government deficits turned out to be unsustainable. This was the outcome of slumping competitiveness and slow growth. It also became evident that the banking sector in any country is highly dependent on the sovereign market of the home country.

The outcome was unfortunate and highly costly. In Greece, Ireland and Portugal banks have lost their access to interbank markets. They have become dependent on the central bank's liquidity provision.

Eurosystem has provided liquidity at various stages of the crises, in different ways, and at various maturities. These were known as non-standard measures. The response of the central banks around the world can be characterized similarly.

Within the euro area the maturities of lending operations were extended from three months up to one year and fixed rate full allotment auctions were introduced. Non-standard measures were introduced aimed at restoring a more normal functioning of the transmission mechanism and an environment where the standard measures could operate effectively.

One of the lessons from the crisis is that the terms and conditions of how collateral is priced are vital to modern financial markets. The importance of collateral policies of the central banks may not have been sufficiently appreciated from the financial stability perspective. In times of an economic boom banks feel they are very liquid as asset prices increase and emission of new credit flourishes.

When financial markets were encouraged to expand, many decisions were guided by efficiency considerations. Liquidity pools and acceptance of various assets and asset classes as collateral to central bank credit made it very easy for banks to rely on central bank financing or short term market financing in general.

The Eurosystem can extend credit only against adequate collateral. Before the crisis, the Eurosystem accepted a wider set of assets as collateral than most of its peer institutions did. Furthermore, some of the collateral eligibility criteria were expended during the financial market crises. Once the still ongoing series of crisis becomes economic history, we should rethink our collateral policy.

One possibility, suggested by our in-house analysis, is to make a clearer separation between the assets that are eligible for monetary policy operations and the assets that are eligible for operations addressing banks' specific liquidity needs. For example, the Eurosystem could limit the set of collateral eligible to Main Refinancing Operations – the weekly operations by which the monetary policy stance is signalled – to the assets eligible for the most liquid private repo markets. Through this, the monetary policy operations would more directly affect the market rates relevant for monetary policy transmission, instead of impacting rates that carry significant liquidity and credit risk premia compared to the market repo rates. The central bank would clearly be the rate setter with its policy operations.

Less liquid assets could continue to be eligible for marginal lending, being used to cover banks' temporary liquidity needs, and possibly also for longer term and other structural liquidity providing operations, if the banking sector's liquidity deficit, i.e. banks' structural need for central bank reserves, remains wide. Contrary to the policy operation, the Eurosystem normally acts as a rate taker in longer term operations. Hence, the lower liquidity of the collateral eligible in these operations would be priced by the market demand.

Using this kind of segregation of collateral, between the different functions that can be assigned to various operations, the Eurosystem would not only assist its control over the risk free short term interest rates, but this idea could also be used to facilitate the monetary policy implementation once the Basel III liquidity regulation becomes effective. For example, the assets eligible for Main Refinancing Operations could equal the set of debt instruments meeting the Basel III Level 1 criteria.

Greater focus on financial stability and macroprudential oversight[1]

The latter part of my presentation is related to the conduct of macroprudential policies.

One of the key lessons of the latest global financial crisis is that central banks – and other authorities – need to pay much more attention to financial stability and macroprudential oversight. New institutions in which central banks play a key role have already been created to identify the emerging systemic risks and to take actions to mitigate these risks. Examples of such institutions include the European Systemic Risk Board (ESRB) in the EU, the Financial Policy Committee (FPC) within the Bank of England and the Financial Stability Oversight Council (FSOC) in the United States.

There is a plethora of open and difficult issues concerning how macroprudential policy should be conducted and which policy instruments are the most efficient in reducing systemic risks. Today, I will set most of these difficult questions aside and concentrate on an issue that has not yet received as much attention as it deserves. How should national macroprudential policies be coordinated so that the combination of these policies would be efficient at the regional or global level?

The recent financial crisis painfully showed how quickly and forcefully financial crises can spread over national borders in a world of integrated financial markets and systems. Because of the ever-deepening financial integration, financial cycles are likely to be highly correlated across countries also in the future.

In such a world, a successful national macroprudential policy entails positive externalities, as a reduction of financial risks in one country contributes to financial stability in other countries. Conversely, a national inaction entails negative externalities, as financial problems are more likely to spread to other countries in the absence of decisive national policy measures.

I argue that in the absence of strong international coordination, national policymakers are likely to fail to internalize these positive externalities. This would lead to a combination of passive national macroprudential policies that are dangerously weak in preventing future global financial crises.

Let me elaborate further.

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1 This section owes much to Tuomas Saarenheimo (2010). Towards a European macroprudential policy. Bank of Finland Bulletin 1/2010.

Consider a strong upturn of an international financial cycle, during which asset prices grow at a fast pace, leverage increases excessively and the pricing of risk declines simultaneously in many countries with interconnected financial markets. This scenario resembles, of course, the developments in the years preceding the latest global financial crisis. To prevent these risks materialising into a systemic global financial crisis, national authorities should tighten their macroprudential policy and possibly other economic policies.

Now, consider the decision-making problem of a macroprudential authority or body in an individual country. This authority may find it difficult to tighten the national macroprudential policy for two reasons.

First, there is a well known problem of "taking the punch bowl away in the middle of the party". This political economy constraint is likely to be even stronger than when interest rates are increased to contain inflation: there is at least some constituency that dislikes inflation, but none that dislikes the intoxicating feeling of getting richer[2].

Second, as I mentioned earlier, a country which is tightening its macroprudential policy in isolation would internalise only part of the financial stability benefits of macroprudential tightening while bearing all the perceived costs in terms of the reduced competitiveness of the national financial industry. This may lead to a *first-mover disadvantage problem*, where no country is willing to be the first to tighten its macroprudential policy unless it knows that other countries are committed to doing the same.

Unless properly addressed, these disincentives to pursue active national macroprudential policies may lead to a *bad equilibrium*, where global macroprudential policies become overly passive. This implies that the identification of effective macroprudential instruments – which in itself is a formidable task – does not guarantee that these instruments are used efficiently either at the national or global level.

What can we do to avoid this bad equilibrium? I have three suggestions.

First, to decrease the extensive political pressure not to take action, we should try to develop and improve the *rules-based macroprudential policy instruments* as much as possible. These instruments, such as the *dynamic loan loss provisions* used in Spain and the capital conservation buffer of the Basel III framework, act at best as automatic stabilisers that do not require continuous discretionary policy decisions. The *countercyclical capital buffer requirement* included in the Basel III framework also includes a rules-based element, as national authorities are advised to use an indicator developed by the Basel Committee as a benchmark in their national buffer decisions.

Economists in the Bank of Finland have done some preliminary analysis on the feasibility of *rules-based loan-to-value requirements*[3]. I urge the research community to intensify its efforts to develop simple and robust rules-based macroprudential tools.

Second, national macroprudential authorities need strong enough mandates, independence and legitimacy to make their discretionary macroprudential policy decisions. Efficient macroprudential actions will be highly unpopular. The costs of these actions are immediate whereas their benefits become visible only in the years to come. The weaker the macroprudential authorities, the more likely they are to bow under the political pressure and not intervene in the developing systemic risks.

Third, to reduce the first-mover disadvantage problem, we need a strong international coordination of national macroprudential policies. In the EU, the European Systemic Risk Board should take this coordinating role.

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2 Claudio Borio (2010). Implementing a macroprudential framework: Blending boldness and realism. Speech, 22.7.2010.

3 Juhana Hukkinen and Karlo Kauko (2011). Macroprudential tools (in Finnish), unpublished, Bank of Finland.

Without doubt, this is a difficult task. The ESRB has to strike the right balance between directing its recommendations on macroprudential policies to individual authorities and making collective recommendations to a larger group of authorities. Individual recommendations may be more effective in alleviating the first-mover coordination problem but may, at worst, be regarded by national authorities as a critique that they have failed to do their job properly. In such a case, their response may be defensive rather than constructive. Collective recommendations, in turn, would largely remove the stigma related to individually targeted recommendations but be less effective in reducing the problem of first-mover disadvantage.

Finding a workable solution to this trade-off will be one the ESRB´s key challenges in the coming years.

I thank you for your attention.