Jean-Claude Trichet: Intervention at the Eurofi Financial Forum 2011

Speech by Jean-Claude Trichet, President of the European Central Bank, at the Eurofi Financial Forum 2011, Wroclaw, 15 September 2011.

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Ladies and gentlemen,

It is a great pleasure for me to be back here at the Eurofi Financial Forum.

These events always provide a very good opportunity to exchange views on issues that are central to the effective functioning of the financial sector and its key task of supporting sustainable growth in the real economy.

As we are all well aware, this is a very challenging time for the advanced economies. We avoided a dramatic economic depression in the autumn of 2008 – following the collapse of Lehman Brothers three years ago to this very day. But we still have a long way to go to move beyond this crisis.

At the Pittsburgh Summit two years ago, the G20 leaders reiterated their promise to do "everything necessary to ensure recovery, to repair our financial systems and to maintain the global flow of capital". Now, more than ever, we need to make significant progress in delivering on those promises.

Today, I would like to focus on what has been achieved so far by our collective efforts to repair our financial systems – in particular, the establishment of the new European supervisory structure, the agreement on Basel III and the global framework for systemically important financial institutions (SIFIs).

But I also want to look at the road ahead: we must not stop here and leave our task half-finished.

There is still very important work to be done on a number of regulatory challenges.

And with all our reforms and with all our new institutions of economic and financial governance, we must ensure timely implementation so that we can ensure that we have done everything to make a difference as regards the resilience of the global, regional and national financial systems.

The ESRB

Let me start with some of our accomplishments before moving on to highlight some key areas where we need to make progress. The first accomplishment is the establishment of the European Systemic Risk Board (ESRB) earlier this year. As you know, the ESRB brings together the policy makers such as central banks, supervisors and the Commission, thus fostering a broad-based review of risks and vulnerabilities and a deeper understanding of interlinkages and spillovers between different parts of the financial system. This wide-ranging perspective, which encompasses both micro and macro elements, is an essential feature of the new European supervisory framework and it fills a gap identified at the global level. Although the ESRB does not have direct binding powers, the effectiveness of its "comply or explain" mechanism builds upon the high reputation of the ESRB's members and the quality of its analysis.

In its last meeting in June, the ESRB underlined the threat to financial stability stemming from the interplay between the vulnerabilities of public finances in certain EU Member States and the banking system, with potential contagion effects across the Union and beyond. To ensure the resilience of the EU financial system and limit the potential for adverse spillovers,

the ESRB at the time also stated that backstop plans should exist, starting with resources from private markets and, if necessary, with public funds.

As we also said at the time, we are furthermore working on specific issues such as FX lending, complex financial products and mismatches in the funding structure between various currencies. Let me mention that we have our next ESRB General Board meeting next Wednesday.

Basel III implementation

As regards Basel III, compared with Basel II, the new framework envisages higher minimum capital requirements, better risk capture, stricter definition of eligible capital elements and more transparency. These elements should substantially improve banks' capital position and loss absorbing capacity, thus enhancing the resilience of the financial sector.

The new Basel framework also introduces entirely new concepts, such as a non-risk-based leverage ratio and mandatory liquidity requirements. It has been agreed that these measures will be introduced gradually during a transition period. It is essential that prior to their introduction the potential impacts of these new elements on financial markets are carefully assessed to ensure that these measures do not hinder banks providing funding to the real economy.

A major challenge ahead is the consistent and timely implementation of the Basel III framework. It is of the essence that we all adhere to the agreed timeline, ensuring that our banks have a strong capital base. Only when implemented in a consistent manner across jurisdictions will the expected significant net social benefits, including reduced volatility of credit and GDP growth as well as the lower probability of occurrence of systemic crises, be achieved. To reap the benefits of the new framework, a consistent implementation of Basel III is essential.

In this context, I welcome the European Commission's proposal on the implementation of Basel III in the EU, issued in July in the form of a fully-fledged capital requirements regulation.

With this step, the EU has demonstrated its strong commitment to the rapid implementation of the Basel III agreement. As it was already said earlier in this Eurofi colloquium, great attention is presently given to this very important piece of legislation, to verify and make sure that it is fully in line with the agreements reached at global level through the Basel Committee, the FSB and the G20. I am confident that this work will be satisfactorily concluded.

SIFIS

Another important step taken to strengthen the resilience of the financial markets is the agreement reached on global systemically important financial institutions. A key lesson from the crisis is that incentives need to be put in place for banks to reduce their "systemic footprint".

So I am very pleased that at end-June this year the Group of Governors and Heads of Supervision, which I had the privilege to chair, adopted the consultative document regarding global systemically important banks. The envisaged measures have several objectives. These objectives include reducing the probability of an adverse event occurring, reducing the extent or impact of the failure of a systemically important bank and reducing the cost to the public sector.

The framework is built on two building blocks that increase the loss absorbency of global systemically important banks. The first building block is a gradual capital surcharge based on the degree of systemic importance, ranging from 1% to 2.5 % of risk weighted assets.

The second building block is that the additional capital requirements have to be met with common equity. The unambiguous choice of common equity as the unique instrument to meet the capital surcharge should ensure robustness. These measures complemented with supervisory judgement should capture structural and cyclical changes in the banking system.

Shadow banking

The introduction of more stringent capital requirements for credit institutions under Basel III as well as the requirements for global systemically important banks, may provide incentives for banks to shift part of their activities outside the regulatory perimeter. It is therefore decisive that we continue our work to improve our capacity to identify and assess the potential risks stemming from the shadow banking system.

We need to develop a better understanding of the interconnections between regulated and non-regulated entities. We also need to explore the possible channels of contagion that may result in adverse market dynamics. Gaining a better understanding of the functioning of the shadow banking system is a key element of and a precondition for improving the efficiency of financial regulation and supervision across markets and jurisdiction.

I strongly encourage the FSB to continue to work very actively on all of its work streams regarding the regulation of the non-banking sector. This includes regulatory reform of money market funds, securitisation and the interaction with the banking sector. I am looking forward to the progress report to be delivered for the G20 meeting in October.

Further regulatory challenges

In a number of key domains, decisions have been taken by the international community. It is no time to challenge them. It is time to implement.

In a crisis period where confidence is of the essence, it would be extremely damaging if the authorities were to hesitate, demonstrate an absence of resolve and of the fortitude that is required by the circumstances. I see resistance of some in the financial sector against Basel III. I see similar messages on the SIFIs. For me, it is crystal clear: what has been decided is decided.

But there are other areas of regulatory reform where work is still underway. Let me briefly highlight two key areas on which we need to stay committed and where swift progress is of the essence.

First, there is the review of the Markets in Financial Instrument Directive (MiFID), on which a proposal is expected to be released by the European Commission this autumn, will represent a key step in the right direction. Amending the MiFID should enable the EU regulatory framework to keep pace with financial innovation while responding to the G20 commitments to deal with less regulated and more opaque parts of the financial system.

Second, it is key that transparency is enhanced across the board: with regard to markets, institutions and products. Lack of information contributes to the mispricing of risks, mistrust among market participants can turn situations into downturns. In order to build confidence and contribute towards the stability of markets it is important that financial innovation and technological advances contribute to the ability of financial markets to sustainably provide financial services to the real economy. We need to establish a harmonised framework that enables coordinated action, increases transparency and reduces the risks posed by these market practices. Moreover, we need to better identify, monitor and assess the potential threat to market stability posed by High Frequency Trading.

The IOSCO consultation on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity, carried out in response to a G20 Leaders request during the Seoul Summit in 2010, recalls that "the benefits from technological advances should not

overshadow the risks that these innovations pose to the efficiency and integrity of markets. These changes raise issues that should be addressed by regulators in order to maintain the integrity of financial markets." IOSCO is currently assessing the responses to this Consultation and steps that could be taken to help mitigate these possible risks. I look forward to the report for the G20 Finance Ministers in October.

Conclusion

In conclusion I would like to send these messages and make a comment on the central banks role in present time:

My first message is to underline once again that all what has been decided has to be implemented strictly, comprehensively, and fully. As the continuous challenges demonstrate clearly, we are not back to "business as usual" as some thought some months ago. We need resolve and fortitude of the public authorities and lucidity on the part of the private sector.

Secondly, a lot remains to be done. No complacency should be tolerated in any field. And I cannot help saying that on top of what is clearly identified by the international community as the urgent issues in discussion in the Financial Stability Board, we are far from understanding the potential global systemic instability that is associated today with the sheer size of the non-banking sector which experienced an exponential growth over the last 20 years. I would call all of us to better understand this aspect of the global financial dynamics.

Thirdly, more directly linked to the present tensions in the European sovereign debt, I would only remind all of us that the central banks – and the ECB in particular but with all others – have called permanently for sound fiscal management, sound economic policies and structural reforms, strict implementation and reinforcement of the European economic and fiscal governance – tirelessly, not only in stress times, but also in times of generalised benign neglect of both governments and markets. We call all authorities to implement swiftly all decisions and to be constantly ahead of the curve. As institutions that are independent, that are devoted to stability and that are medium- to long-term oriented, central banks are more than ever an anchor of stability and confidence. This is especially the case in an environment which is turbulent since 4 years, in open crisis of the financial sector since 3 years – shall I say exactly 3 years – and in a market environment characterised by acute tensions of some sovereign signatures in the advanced economies since one year and a half. It is exactly what is inspiring the Governing Council and the General Council of the ECB: to offer the most solid anchor of stability possible to all economic agents and, overall, to our own people. For in very difficult times, all depends on the confidence of our fellow citizens. It is what is inspiring the 27 central banks of the European Union. It is what is inspiring the sister central banks in all the world.

We are just coming from Basel, the BIS headquarters. Reporting to the press on the Global Economy Meeting, I stressed that we were all very closely "united in purpose": each of us in our own economy, with their different features and challenges, striving to solidly anchor inflation expectations, preserve stability and consolidate confidence.

The globally co-ordinated decision we published this afternoon on US dollar liquidity-providing operations is a clear illustration of our very close cooperation at the global level and of the "unity in purpose" that I was mentioning last Monday.

I thank you very much for your attention.