Benoît Cœuré: Challenges facing financial integration and financial stability

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the 3rd Pan-Asian Regulatory Summit, organised by Thomson Reuters, Hong Kong, 28 November 2012.

*   *   *

Ladies and Gentlemen,

It is a great pleasure to be here in Hong Kong and I would like to take the opportunity to thank Thomson Reuters for having invited me to speak at the 3rd Pan-Asian Regulatory Summit.

Today I would like to focus on three closely interrelated issues: first, I'll discuss some key questions related to financial integration and financial stability, and second, I'll touch upon the nexus between financial integration and financial stability on the one hand, and monetary policy on the other hand, highlighting some key challenges that the ECB faces today. I'll conclude my talk with some general remarks on the global perspective on financial regulatory reform.

Financial stability and financial integration

Policy debates on the relationship between financial stability and financial integration have intensified in the past few years and the topic has become a high priority on the research agendas of central banks and academia. The increased attention is justified on account of recent experiences in the financial crisis which provided ample evidence of how quickly financial distress can spread from one institution to another, or from one financial system to another, in today's globally integrated financial markets. Several jurisdictions reacted to these developments by "ring-fencing" certain institutions or business lines. At the same time, financial institutions were also keen to lower their cross-border exposures in order to reduce the riskiness of their portfolios abroad. These efforts resulted in increased market fragmentation, in particular in Europe, with adverse consequences on monetary policy and financial intermediation.

There is now a consensus that a financial system which is stable across jurisdictions can foster financial integration. As the ECB's most recent Financial Integration in Europe report indicated, stable, highly integrated and adequately supervised markets contribute to a more efficient allocation of resources over time and across jurisdictions, allow inter-temporal smoothing of consumption and increase the supply of funds for profitable investment opportunities. Furthermore, higher levels of financial integration also enhance competition and reduce the costs of intermediation, thus contributing to more sustainable economic growth.

Naturally, the question arises whether this positive reinforcing relationship between financial stability and financial integration also works the other way around – i.e. does financial integration also enhance financial stability? My answer to this question is yes, provided that certain conditions are met. Let me elaborate.

First, we should have the appropriate policy tools to ensure that financial integration does not result in the development of opaque instruments and business activities which diminish transparency and undermine confidence in financial markets.

Second, we know that financial markets are prone to short-sightedness, herd behaviour and sudden changes in market sentiment which may be detrimental to financial integration and stability. It is therefore important that the incentives of managers and employees are aligned with the risks they are taking in order to ensure that the long-term viability of financial institutions is appropriately taken into account in business decisions.

Third, we have to prevent financial integration from leading to an excessive concentration of risks and leverage in the balance sheets of financial institutions. This may pose a risk to systemic stability.

Fourth, we should have the tools to mitigate the risks of contagion across institutions and jurisdictions and, should problems arise, we need to be in a position to be able to resolve ailing banks in a timely manner within an efficient framework of crisis management and resolution.

Finally, we have to ensure that all types of risk and all types of financial activity that may imperil financial stability and financial integration are monitored, assessed and supervised in a comprehensive way.

Overall, all the steps taken to enhance financial integration need to be complemented by efforts at international level to design and implement consistent policy measures that can help to strengthen the resilience of the global financial system and reduce global systemic risks.

In 2009, G20 leaders agreed that all systematically important financial institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight. The policy agenda has made good progress and I particularly welcome the latest Financial Stability Board (FSB) report on the shadow banking industry.[1]

Financial integration, financial stability and monetary policy

I would like to stress the importance of a well-integrated financial system for the effectiveness of the single monetary policy in the euro area. Financial integration is one of the key preconditions to ensure that the ECB's monetary policy stance is appropriately reflected across the euro area countries, thereby reducing heterogeneity in the monetary policy transmission mechanism. The most immediate impact of changes in key policy rates is transmitted via money markets. Hence, to have a broadly homogeneous impact across banks and jurisdictions, fully integrated money markets would allow full access to markets and similar marginal costs for banks with similar creditworthiness.

Likewise, the integration of further wholesale funding market segments, such as markets for debt securities and securitised assets, facilitates the smooth transmission of monetary policy decisions on banks' funding costs. Further down in the intermediation chain, the integration of banks' wholesale funding markets significantly contributes to homogenising the pass-through of monetary policy decisions on bank lending rates.

In general, financial market integration allows the banking system and corporate debt markets to facilitate risk-sharing and efficient capital allocation across economies and, thereby, allow companies and households to reap the full benefits of freely mobile capital.

In this context, the financial crisis and the more recent sovereign debt crisis had a strong adverse impact on euro area financial markets. Increasing price and return differentials for *a priori* similar categories of borrowers and lenders were the result and translated into rising disparities in market conditions across euro area countries. These developments led to a fragmentation in bank funding markets and other parts of the financial markets.

Such distortions constituted specific impairments of the monetary policy transmission mechanism. Since the start of the financial crisis, the ECB has introduced an ample range of

1 Financial Stability Board: Initial Integrated Set of Recommendations to Strengthen Oversight and Regulation of Shadow Banking, 18 November 2012.

targeted standard and non-standard policy measures to address these impairments. And indeed, focusing on the last 12 months, we have observed our latest measures – the three-year Long Term Refinancing Operations (LTROs) and, most recently, the announcement of outright monetary transactions (OMTs) – as having a positive impact on banks' funding. This is evidenced, for instance, by the decline in bank bond spreads and renewed primary issuance across jurisdictions. Replies to the Eurosystem's Bank Lending Survey have also indicated an improvement in banks' funding and liquidity conditions across jurisdictions for the same reasons. Let me confirm that the ECB is ready to undertake OMTs whenever a country has successfully applied for an ESM precautionary assistance programme, with IMF involvement.

The ECB can address the symptoms but not the root causes of financial market fragmentation. The cures for the disease are very well known: first, ensure the solvency of sovereigns; second, make individual banks safer and more resilient and introduce appropriate macro-prudential instruments to address systemic risk; and third, break the link between the creditworthiness of banks and sovereigns.

I will now elaborate on the second and third aspects from a central bank's perspective. The crisis has also revealed two major lessons for our supervisory framework. The first is that macro-prudential factors should play a much larger role in the approach followed by supervisors. The second is that a common banking supervisor is essential for an efficient monetary union.

Turning to the first, and again looking back at the pre-crisis period, banking supervision was essentially "micro-based". It mostly focused on ensuring the safety and soundness of *individual* institutions, while taking the rest of the financial system as a given. The implicit assumption was that stable individual institutions would automatically ensure a stable system. This micro-based supervisory approach was likely to underestimate the systemic component and was not able to internalise and target the negative externalities that could have built up as a result of increased risks for the system as a whole.

The lending booms we experienced in some euro area countries before the crisis are a good illustration of the problems arising from an excessive reliance on this micro-prudential approach. During the upswing, banks reported high levels of profitability and low levels of measured risk. Both of these factors tend to improve capital ratios, offering a reassuring picture of the solvency of individual banks from a micro-supervisory perspective. Yet historical experience shows that rapid credit growth usually comes at the cost of increasing the systemic – or tail – risks, for instance, by lowering lending standards via undiversified housing exposures or excessive reliance on short-term market funding. Again, the crisis raised awareness both of the endogenous nature of many systemic episodes of financial instability and of their negative externalities that could be of great importance in determining macroeconomic outcomes.

From a policy perspective, the new focus has led to an increased interest in the macro-prudential approach to bank regulation and supervision. In Europe, the new regulatory and supervisory infrastructure about to be adopted will provide supervisors with macro-prudential tools.[2] European economies face different economic and financial cycles and different types of systemic risk, and their financial sectors still exhibit different structural features. The ECB therefore considers it important that authorities can apply stricter macro-prudential requirements at national level.[3]

---

2 Examples are the counter-cyclical buffer or the possibility for national authorities to adjust risk weights or set stricter criteria, e.g. loan-to-value ratio, for exposures secured on residential or commercial real estate.

3 European Central Bank: Opinion on a proposal for a Directive on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and a proposal for a Regulation on prudential requirements for credit institutions and investment firms (CON/2012/5), 25 January 2012.

This does not imply that the soundness of individual institutions should matter less. It is vital that euro area banks are adequately capitalised and self-insured against liquidity risks. The European Banking Authority's EU Capital Exercise, completed in October 2012,[4] has prompted a capital injection of more than €200 billion in European banks. As the EBA pointed out, it is now important that banks maintain their capital levels on the path to the Basel III framework.

The other important lesson from the crisis is the fundamental inconsistency between the single monetary policy of the euro area and the national responsibilities for banking policies. A key feature of the present crisis is the increase in the correlation between the cost of funding of euro area banks and that of their respective sovereigns, particularly in some peripheral economies. Countries suffering from a loss of market confidence have become progressively more dependent on domestic sources of funding and less responsive to common monetary policy impulses. The divergence in bank funding conditions at national level, in turn, gives rise to cross-country differences in lending conditions. The retrenchment of credit supply within national borders, coupled with funding pressures, impairs the transmission of monetary policy, which in the euro area functions primarily via the banking sector.

The need to sever the negative feedback loop between banks and sovereigns by taking responsibility for the stability of the banking system at European level has become clear. Following the euro area summit of 29 June 2012, the European Commission presented a proposal to establish a single supervisory mechanism (SSM) involving the ECB, on the basis of Article 127.6 of the Treaty on the Functioning of the European Union.

The implementation of the single supervisory mechanism is key not only to enhancing financial stability but also to strengthening financial integration in Europe. Let me comment on three aspects of the SSM which are currently under discussion.

First, all banks should be covered by the SSM, so as to have a level playing field and to support further integration of the industry. Many supervisory tasks – probably most of them – should be undertaken by national supervisors; after all, most euro area governors already fulfil supervisory responsibilities. However, this should be within a centralised decision-making process and according to a single handbook.

Second, there should be a clear separation between supervisory decision-making and monetary policy. Under the European Commission proposal, a separate Supervisory Board within the ECB would take most supervisory decisions, under the ultimate authority of the ECB Governing Council.

Third, the SSM is *necessary* for the euro area but it may be desirable for other European countries as well. Arrangements are being worked out on the basis of Article 127.6 of the Treaty to allow them to participate and be fairly involved in the decision-making process.

I am confident that European leaders can agree in December on the final features of the SSM and confirm that it will start legally in January 2013 and operationally in 2014. Let me add a final remark. The SSM will turn the ECB into the home supervisor of all euro area banks. But there cannot be a lasting situation with one single supervisor and 17 (or more) uncoordinated resolution authorities. As Mervyn King once noted, "global banks are global in life but national in death". European banks should be European in death. I look forward to the European Commission proposing a single resolution mechanism as soon as possible in 2013.

---

[4] European Banking Authority: Final results of the EU Capital Exercise, 3 October 2012.

Global perspective on financial regulatory reform

I would like to conclude my talk with some general remarks on the global perspective on financial regulatory reform.

Concerning the global policy response to the crisis, the G20, the Financial Stability Board and the Basel Committee for Banking Supervision (BCBS) are all playing a key role in defining and prioritising the global regulatory reform agenda, coordinating the ongoing work on standard setting, and monitoring the implementation of measures that have already been agreed upon. Also, the Committee for Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO) are playing a leading role in the crucial field of financial market infrastructures.[5]

While the regulatory framework is currently undergoing a complete overhaul, the work is often perceived as being quite technical and difficult to follow by non-experts. This is why it is important that ongoing efforts are well understood and supported by all stakeholders, including the general public. Policy-makers should therefore clearly explain how the global regulatory reform measures are linked to the lessons drawn from the crisis and how these policy measures may promote global financial stability and, ultimately, economic growth.

These reform efforts enjoy unequivocal support in Europe. Let me briefly recall in this regard that the EU has been one of the main jurisdictions which first implemented Basel II and Basel II.5, and remains committed to promptly implementing Basel III, which I consider as a cornerstone of the G20 reform agenda. Timely and consistent implementation of the new regulatory standards as well as uniform assessment of the implementation process based on common evaluation standards around the globe are crucial for strengthening the resilience of financial systems and restoring confidence in markets. Delayed implementation of Basel II.5 and Basel III by any major jurisdiction would weaken the incentives for financial institutions to comply and also cast serious doubt on the overall reform effort.

Finally, an area where, in my view, enhanced coordination is required concerns the structural measures being proposed in different jurisdictions. Since recent initiatives in the US (Volcker rule), the UK (Vickers report) and the EU (Liikanen report, on which the European Commission will now follow up) will mainly target internationally active banks, coordination at global level in this policy area is important to ensure a level playing field and to avoid regulatory arbitrage by banks with significant cross-border activities.

Clearly, regulators, supervisors as well as financial institutions are facing several challenges in the years ahead both as regards policy design and implementation. There is a risk that weak economic growth and an increasing focus on domestic policy priorities can weaken the incentives and appetite for coordinated reform efforts. But well-integrated and well-regulated financial markets are needed more than ever for sustainable and stable growth, both at global and at regional level. But I'm confident that a successful accomplishment of the reform agenda and a consistent implementation of the policy measures will help to achieve this goal.

I thank you for your attention.

---

[5] CPSS and IOSCO: Principles for financial market infrastructures. April 2012.