Yves Mersch: Financial stability policies in central banks

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the seminar: "Financial stability policies in a post-crisis world", Czech National Bank, Prague, 4 March 2013.

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Financial cycles and the real economy

The global financial crisis has resulted in enormous losses for the real economy and taxpayers in many countries. For policy-makers it has triggered a re-discovery of the analysis of financial cycles and their impact on macroeconomic dynamics.

Although important steps have been taken to improve the prevailing analytical framework, e.g. by incorporating financial frictions in general equilibrium models, these models are in most cases not yet capable of properly taking into account the relationship between the real economy and the financial markets.

I fully agree in this regard with Claudio Borio, who has published (together with his colleagues at the BIS) a range of analytical papers on this topic in the last few years and stated that a proper understanding of financial and leverage cycles is essential for effective policy-making.

Indeed, we are aware of the shortcomings of our analytical capacity and attach high priority to enhancing our knowledge of the interactions between financial and real economic cycles. This will be key to helping decision-makers find the appropriate policy responses to the build-up of excessive systemic risks and thus to prevent the real economy, and ultimately the taxpayers, from the potential adverse impacts of unsustainable financial imbalances.

The institutional framework and instruments of macro-prudential policy

Systemic risks require a comprehensive, systemic policy response. A number of concrete measures have already been taken around the world to set up an appropriate institutional framework for systemic risk analysis and macro-prudential policy-making. Given, however, that we are currently in the "infancy" of macro-prudential policy-making, the evolving institutional framework still varies quite substantially across jurisdictions.

We have models of single institutions (typically central banks), or, alternatively, financial stability boards or committees that are designated to carry out macro-prudential policies. From a financial stability perspective, it is important that the authorities responsible for macro-prudential policies should have (i) a well-defined mandate, (ii) clearly established long-term and intermediate objectives, and (iii) sufficient control over macro-prudential instruments that can be activated (or de-activated) in periods when risks to financial stability have been identified.

Macro-prudential policy framework in Europe

In Europe, the institutional response to these policy challenges was the establishment of the European Systemic Risk Board (ESRB), which has a clearly defined mandate and responsibility in macro-prudential policy-making and coordination at EU level. Having issued its recommendation on the mandate of national macro-prudential authorities, the ESRB also plays a key role in facilitating the establishment of a macro-prudential policy framework at the level of individual Member States.

However, the ESRB does not have direct control over the instruments that are to be used to address systemic risks. While the ESRB can issue recommendations on the application of policy tools, the macro-prudential instruments are ultimately in the hands of national authorities. Therefore, close cooperation between Member States is unavoidable both as regards the assessment of systemic risk and the implementation of macro-prudential policy. This framework will in the future be complemented by the macro-prudential tasks and responsibilities conferred upon the ECB as envisaged in the upcoming Regulation on the Single Supervisory Mechanism (SSM).

Relationship with monetary policy

Given the key role that central banks play in financial stability analysis and macro-prudential policy-making, the question on the relationship with monetary policy naturally arises. The ECB has a clear mandate to preserve price stability over the medium term. However, it may be desirable to incorporate in the decision-making process of monetary policy certain financial variables, which, over the medium to longer term, may influence inflationary developments (e.g. excessive credit growth, asset bubbles etc.).

At the same time, it has to be acknowledged that monetary policy may have its limits in periods when the banking system and the non-bank private sector are busy repairing their balance sheets, i.e. correcting the excessive leverage that they built up in good times. Properly designed and calibrated macro-prudential policies may help to avoid these situations and may thus support the repair of the monetary transmission mechanism.

Furthermore, there is growing evidence that monetary policy itself may contribute to the fluctuation of risk aversion and risk taking in the banking system over time. Concretely, banks can react to the actual stance of monetary policy by changing the composition and the risk profile of their portfolio ("risk-taking channel" of monetary policy). This is another example of how macro-prudential policies can contribute to the effective conduct of monetary policy by addressing cyclical swings in risk taking in a timely manner.

Overall, being responsible for monetary policy means that central banks have an intrinsic and deep interest in a stable financial system. It is therefore desirable that central banks also play a role in financial stability policies, both at the micro and macro levels. The reasons for this are manifold. Let me mention three. First, there are substantial information-related synergies between monetary policy, the supervision of banks and the oversight of payment systems. Second, central banks have already built up expertise on the financial sector as part of the financial stability analysis which could serve as a solid basis for policy actions as well. Third, the operational and institutional independence of central banks, with clearly defined rules of accountability, are important assets that can also contribute to the effective conduct of financial stability policies.

Establishment of the Single Supervisory Mechanism

Monetary policy has clear limitations in addressing macroeconomic imbalances in individual countries within a monetary union. To overcome these limitations and to achieve systemic stability in an integrated financial market, national financial policies should be complemented by a mechanism that enhances coordination and centralises decision-making as well as policy action in certain key areas of micro- and macro-prudential policy. This is the underlying reason for the establishment of the Single Supervisory Mechanism (SSM), with the ECB at its core. There are strong arguments in favour of a central authority that can have a comprehensive, well-informed and unbiased view of the entire euro area banking sector and that is not held hostage by national interests and potential inaction bias.

The establishment of the SSM also helps to break the negative feedback loops between sovereigns and banks. The importance of preventing sovereign problems from spreading to banks (e.g. Greece) or preventing problems from banks spreading to sovereigns (e.g. Ireland) are key lessons drawn from the current crisis.

Furthermore, once the SSM is established, the European Stability Mechanism (ESM) may directly recapitalise banks, thus de-linking banks from their sovereigns. This is key particularly in view of the much observed correlation between the cost of funding of euro area banks and that of their respective sovereigns and the subsequent fragmentation of the European banking system.

Macro-prudential aspects of the SSM

The SSM Regulation will charge the ECB with specific tasks concerning financial stability policies. The Regulation explicitly states that the tasks will be conferred on the ECB "with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system within the EU and each Member State". The emphasis on the systemic perspective is further strengthened by a reference to "the unity and integrity of the internal market".

The micro-prudential tasks of the ECB will also have a systemic dimension. Namely, the ECB will take decisions regarding all "significant" banking groups (around 150 banks in the euro area countries). Since these institutions have systemic relevance, prudential measures applied will also have consequences on the stability of the financial system as a whole.

Regarding the macro-prudential tasks conferred on the ECB, the power to initiate and implement macro-prudential measures will primarily remain with the national authorities, subject to a notification mechanism vis-à-vis the ECB. The ECB may object to these measures and the national authorities should duly consider the ECB's reasons prior to proceeding with any decision. Moreover, any national competent or designated authority may propose to the ECB to act in order to address the specific situation of the financial system and the economy in its Member State.

An important feature of the SSM Regulation is that the ECB may, if deemed necessary, also apply macro-prudential measures. These measures include higher requirements for capital buffers as well as more stringent measures to address systemic or macro-prudential risks at the level of credit institutions. The application of these measures is however subject to the conditions and procedures specifically set out in the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR).

The toolbox that is envisaged to be at the disposal of macro-prudential authorities, including the ECB, is rather broad. The set of available instruments defined by the CRD IV includes (i) counter-cyclical capital buffers, (ii) a systemic risk buffer, (iii) a capital surcharge for systemically important financial institutions as well as (iv) Pillar 2 measures applied to groups of institutions. The prudential measures that are falling under the remit of the CRR and that can be used for macro-prudential purposes include (i) capital requirements, (ii) sectoral risk weights, (iii) large exposure limits, (iv) leverage ratio and liquidity requirements, once implemented, and (v) public disclosure requirements.

Additional features of the SSM

When carrying out the tasks conferred upon it, the ECB should act independently and should be accountable to the European Parliament and to the Council. The ECB should submit each year to the European Parliament, the Council, the Commission and the Eurogroup a report on the execution of the tasks conferred upon it.

Furthermore, the ECB will also be accountable to national parliaments.

As concerns the separation from the monetary policy function, the ECB will carry out the supervisory tasks without prejudice to, and separately from, its tasks relating to monetary policy and from any other tasks. The staff involved in carrying out the tasks conferred on the ECB by the Regulation should be organisationally separated and subject to separate reporting lines.

Finally, let me underline that the effective conduct of financial stability policy requires a well-defined decision-making process as well. In this regard, the planning and execution of the tasks will be fully undertaken by the Supervisory Board which will be an internal body composed of a Chair and Vice Chair, four representatives appointed by the ECB, and one representative of the national competent authority in each participating Member State. It is important to highlight from a macro-prudential policy perspective that in cases where the competent authority is not a central bank, the member of the Supervisory Board may decide to bring a representative from the Member State’s central bank. Thus, central banks may also have a word in the decision-making process. Note that, for the purposes of the voting procedure, the representatives of the authorities of any one Member State should together be considered as one member.

The Supervisory Board will carry out preparatory work regarding the supervisory tasks conferred upon the ECB and propose to the Governing Council of the ECB complete draft decisions to be adopted by the latter, pursuant to a procedure to be established by the ECB.