Yannis Stournaras: Financial stability and growth – the role of central banks and the pre-requisites for sustainable growth in Europe

Keynote speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 33rd International Financial Law Conference "Financial stability and growth: the role of central banks and the pre-requisites for sustainable growth in Europe", co-presented by the IBA Banking Law Committee and IBA Securities Law Committee and supported by the IBA European Regional Forum, Athens, 20 May 2016.

* * *

Ladies and gentlemen,

It is a great pleasure to be with you today and to have the opportunity to share with you some thoughts on financial stability in Europe.

Systemic financial stability is a critical condition for achieving our common goals of prosperity and sustainable growth. At the outbreak of the international financial crisis in 2008, central banks and regulatory mechanisms lacked a well-tried toolbox for containing systemic instability and for preventing its build-up. With the measures taken and mechanisms established in subsequent years, that picture has changed substantially, as market participants, regulators, supervisors, macroprudential authorities and others quickly dealt with the challenges. Not only have we seen the transformation of banking supervision through the creation of the European Banking Union with its three pillars, the Single Supervisory Mechanism, the Single Resolution Mechanism and the still-to-be-implemented common deposit guarantee scheme, but we have also seen increased recognition of the importance of systemic stability and the role that macro-prudential policies can play in fostering it. Traditional banking supervision is more focused on individual institutions and the prevention or management of isolated instances of bank failures. Macro-prudential regulation, by contrast, focuses on the system as a whole and largely seeks to ***prevent*** systemic instability and to limit the consequence of systemic distress for the macro economy.

But if financial stability is crucial for growth, the crisis has also taught us that growth is crucial for financial stability. Sluggish growth in the euro area, in spite of unprecedented monetary policy loosening, has weakened European banks, not least through the rise in NPLs, thus hampering their ability to finance the real economy.

In order to explore these ideas, I initially examine this new role for central banks and the tools that have been – indeed, are still being – developed in an attempt to strengthen the resilience of the financial system. Developments in the EU regulatory framework in this area are discussed. I then outline some of the challenges ahead and, finally, provide some thoughts on euro area growth.

A. Central banks and macro-prudential policy

The challenges facing EU financial sectors in recent years have significantly increased the responsibilities of central banks in the area of crisis prevention. Mandates have been amended to explicitly refer to financial stability as a core central bank task. Thus central banks are charged with limiting system-wide distress and, ultimately, avoiding its negative consequences for the real economy.

In the past, it was not thought necessary to separate monetary policy from the task of providing financial stability. It was thought that price stability in the market for goods and services would be sufficient to ensure financial stability in asset markets. Experience has dispelled such beliefs and has shown that the business cycle and the financial cycle are not necessarily synchronized; long periods of disconnect between the two cycles can

materialize. In particular, the financial cycle tends to have larger amplitude and lower frequency than the normal business cycle.

Macro-prudential policy bridges the gap between the traditional micro-prudential supervision of individual banks and monetary policy. Its objectives are, first, to enhance the resilience of financial institutions and the entire financial system, and, second, to smooth the financial cycle. In this regard, macro-prudential policy allows monetary policy to focus on maintaining price stability, while micro-prudential supervision focuses on individual institutions. In this way, macro-prudential policy enhances the institutional separation that is one of the principles of the architecture of the euro area.

Whilst separation is important, the usefulness of coordinating policies should not be forgotten – whether that be coordination of specific policies across different countries (as happened in the wake of the failure of Lehman Brothers with the simultaneous cuts in policy rates) or coordination of policies within one jurisdiction. Respect for the independence of the various authorities involved in securing financial stability should not imply separation and a lack of coordination.

B. The macro-prudential toolbox and developments in the EU financial regulatory framework

If macro-prudential policy is to effectively curb the financial cycle, it is essential to have tools that deal with the credit-real estate (or whatever other asset) relationship. There are two ways to deal with this relationship. The first is by imposing restrictions on credit institutions – for example, through capital-based measures. The second is by limiting the degree to which households and non-financial corporations take on leverage.

With regard to credit institutions, the Capital Requirements Regulation (CRR) and Directive (CRD IV) play a prominent role in setting the prudential standards in the EU. Implementation is ongoing and expected to be completed by 2019. From January 2016, the countercyclical capital buffer (CCB), the systemic risk buffer (SRB) and the other systemically important institutions (OSII) buffer, three important macro-prudential tools, have been operational. However, given the need to diversify the available tools beyond regulations based on capital, tools based on liquidity, leverage and funding sources are also being introduced.

With regard to the borrower's side, instruments such as the loan-to-value (LTV), loan-to-income (LTI) and debt-service-to-income (DSTI) limits are considered to be among the most effective macro-prudential instruments in curtailing excessive credit growth and the build-up of unsustainable debt positions. In order to effectively moderate the financial cycle, a time-varying dimension is crucial in the design of the various ratios. For example, the loan-to-value ratio should be lowered during the expansionary phase of a financial cycle and raised during the contractionary phase, while respecting the mandate of financial stability and avoiding the build-up of systemic risk. Otherwise, there is a risk of pro-cyclicality since leverage constraints decline as asset prices rise.

It is imperative, however, that the macro-prudential toolbox be further enhanced with innovative tools beyond those outlined above. Cyclical systemic risk can arise not only as a result of excessive credit expansion (an issue that can be addressed with the countercyclical capital buffer along with limits on borrowing) but also because of inadequate channeling of credit that keeps the real economy under-financed for extended periods. A lesson drawn from the crisis is that we have focused on rather narrow areas of financial activity. Nowadays, it is important that we focus on the risks that might have been missed such as the interlinkages between sectors, and thus explore how the financial system can influence, and be influenced, by the wider economy. In the euro area, there is evidence of limited financing of the real economy, with the consequence that euro-area investment has not recovered to pre-2008 levels despite ECB policies directly aimed at increasing the lending of the banking sector.

C. Challenges ahead and the way forward

Challenges, of course, remain. Let me point to some that are more relevant for macro-prudential supervision and systemic stability.

1. A first challenge relates to the issue of the increased burden of complying with the new regulatory framework and assessing its cumulative impact. I am not referring to additional capital adequacy requirements but rather to the plethora of new measures being applied by more than one institution. In the pursuit of making banks more robust, liquid, responsible and transparent, huge progress in regulating and supervision their operations has been achieved. However, there has been no estimate of the cumulative impact of these regulations. I welcome and look forward to the report on the impact of capital requirements on the economy; however, the impact of other regulations should also be examined.

We need to keep in mind the principle of proportionality, a general principle of EU law. As new regulations accumulate, they can come with costs as well as with benefits. Policymakers need to be watchful that, in attempting to limit externalities, they do not inadvertently create new externalities. The financial sector ultimately exists to serve the real economy. It is very likely that there are trade-offs between ensuring financial stability and imposing such a burden on the financial sector that it ceases to be able to do its job, namely to intermediate between surplus and deficit units in any economy in order to encourage long-term investment and growth. Thus we have to develop methods to judge the appropriateness of indicators and tools. Since many of the regulations have been applied over the last few years, that is, in a period of acute financial stress, I expect that in the coming years there will be a need to reassess those regulations and perhaps conduct some fine-tuning. Similar arguments apply to the national options and discretion in the new regulatory framework.

2. Closely related to the previous challenge is the degree to which regulatory developments should be front-loaded. The regulations themselves often have long phase-in periods such that new versions of the regulations are developed before the previous versions have been fully implemented. Supervisors have tended to compensate for the long phase-in periods by front-loading all prudential requirements, a situation that sometimes can be considered excessively harsh. Of course the long phase-in periods are often a reaction to the expected impact of the regulation on bank behaviour and, in particular, on the lending to the real economy. Some middle road has to be found.

3. A third challenge is the need to reduce reliance on models. Recently conducted stress-tests, a core macro-prudential tool, followed a "single-model-fits-all" methodology, which left very little room for idiosyncratic and specific national characteristics. Moreover, according to some analysts, there is a risk that stress tests are becoming less effective as a tool. Instead, they may increasingly be seen as being conducted simply to calm financial markets. Ideally, stress tests should be implemented in benign times in accordance with an old wisdom attributed to John F. Kennedy, that "the time to repair the roof is when the sun is shining". In crisis times, there is the risk that crucial inputs such as macroeconomic variables are under or over-estimated and that adverse scenarios become unrealistic – either too benign or too severe. In consequence, outcomes become ambiguous and difficult to interpret. Additionally, the potential pro-cyclical effects of stress tests should be explored. Stress tests should not only place emphasis on solvency, but they should explore the impact of the assumed shock on bank liquidity, the implications of applying the bail-in tool, the funds needed to meet any demand on deposit guarantee funds, etc. We should focus on harmonizing processes, while models should be enriched with constrained judgement as is standard practice in macroeconomic forecasting.

4. Fourth, there is a need to widen the scope of regulation. Systemic fragility may arise from sources other than the traditional banking sector. A crucial challenge ahead is related to recent disintermediation and the development of "shadow" banking as an alternative means of financial intermediation. The need for macro-prudential regulation of certain financial activities becomes clear if we consider that banks and non-banks are closely tied through

market-based intermediation activities. These include a broad array of services related to securitization transactions, securities financing transactions, repos, collateral management and derivatives. The consequences of poorly-monitored risks in this area are unknown and the risk of a new crisis could be lurking, while spill-over effects are difficult to assess. Moreover, the more policymakers are effective in using macro-prudential tools to constrain excessive credit growth in the banking sector, the more likely it becomes that there will be excessive adjustments in the non-bank sector through leakages. Fortunately, “shadow banking” is high on the agenda of the relevant fora and there is a clear need to extend the regulatory toolkit.

5. A fifth challenge, the role of the central bank as a lender of last resort to the banking system, needs to be addressed in the light of the mandate to preserve financial stability. The lender of last resort function is a crucial macro-prudential tool for managing financial distress. The principle developed by Thornton and Bagehot is well-known. Central banks should lend freely to solvent but illiquid banks against good collateral at a high rate of interest. How is this tried and tested principle to be made operational in today’s environment with much larger bank balance sheets and fewer liquid assets? In the past, government bonds were automatically considered good collateral. Today, central banks accept a wider pool of collateral. By what criteria should collateral be judged? We know that liquidity problems can become solvency problems if liquidity is denied or not provided generously enough. Thus the seemingly simple principle developed by Thornton and Bagehot can be open to various interpretations. There is a need, I think, to revisit the question. Mervyn King’s pawnbroker concept (2016) provides some new ideas on the issue.

The ultimate aim in meeting these challenges is to make finance in Europe more resilient and to enhance and safeguard financial stability. The role of supervisors of the financial system is to enhance harmonization while respecting proportionality. They should safeguard a level-playing field among all participants and protect depositors while striking the right balance between “strictness” and “fairness”. Their mandate is to set clear boundaries within which financial intermediation can prosper while financial stability is maintained.

D. Beyond policies towards the financial sector

As I stated at the outset of my presentation, financial stability is not only crucial for growth; growth is also crucial for financial stability. So let me close with a few remarks on growth in the euro area and the completeness of Economic and Monetary Union (EMU).

Despite the progress made in the past few years, EMU remains incomplete. Divergence across the euro area is significant and the crisis has further highlighted existing shortcomings and important differences that need to be bridged. To this end, Europe should build upon other proposals outlined in the Five Presidents’ Report (2015). As argued in that report, EMU will not be complete until the appropriate mechanisms to share fiscal sovereignty are in place. Monetary unions have to develop mechanisms for risk sharing. Mark Carney (2015) recently highlighted the stylized fact that, whatever happens to asset prices, debt endures. Reducing debt levels is difficult and he notes that it is unlikely that high debt in one sector or region can be reduced without at least temporarily increasing it in another. Fiscal integration can help in this respect. Allow me to remind you of Keynes’s view about the Bretton Woods System – it needed, he believed, to provide mechanisms to promote symmetric adjustment within the fixed exchange rate area so that there would not be a bias towards deficient demand across the system. A more-fiscally-integrated monetary union would help address the problems of asymmetric adjustment and the deflationary bias of our monetary union.

Sustainable economic growth can contribute to financial stability. Failure to maintain sustainable growth has been the biggest threat to the long-term stability of the EU since the onset of the 2007 crisis. An appropriate balance between managing risk and enabling investment needs to be struck. In this connection, it is crucial that the regulatory framework does not impede, but provides a suitable environment, for sustainable growth.

Ladies and gentlemen, ultimately, a sustainable recovery will need to be underpinned by higher investment. Yet, in the euro area we presently face a significant investment gap. The financial system and its stability have a crucial role to play in closing this gap. Central bankers and supervisory authorities bear an enormous responsibility in shaping a system that can deliver prosperity to the citizens of Europe. We have made important progress in securing the financial stability needed to deliver such prosperity, but we have not yet completed the job. As the ancient Greek mathematician, Archimedes, once said, "Give me a place to stand and I will move the earth, but first I need a place to stand, a foundation." The completion of our financial-stability edifice will provide the necessary foundation for the citizens of Europe.

Sources:

1. Bank for International Settlements (2015) "Making supervisory stress tests more macroprudential: Considering liquidity and solvency interactions and systemic risk", BCBS Working Papers No 29, https://www.bis.org/bcbs/publ/wp29.htm, November.

2. Banque de France and Bank for International Settlements (2016) "Ultra-low interest rates & challenges for central banks", Farewell Symposium for Christian Noyer, Paris, https://www.banque-france.fr/en/economics-statistics/research/seminars-and-symposiums/symposium-a-loccasion-du-depart-de-christian-noyer-banque-de-france-et-banque-des-reglements-internationaux.html, January.

3. Basel Committee on Banking Supervision (2015), Finalising post-crisis reforms: an update, A report to G20 Leaders, http://www.bis.org/bcbs/publ/d344.pdf, November.

4. Carney, M. (2015) "Fortune favours the bold", Speech given to honour the memory of The Honourable J. M. Flaherty, P.C., Iveagh House, Dublin, http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech794.pdf, January.

5. Cœuré, B. (2016) "Time for a new Lamfalussy moment", Speech at the Professor Lamfalussy Commemorative Conference, Budapest, https://www.ecb.europa.eu/press/key/date/2016/html/sp160201.en.html, February.

6. Cœuré, B. (2016) "From Challenges to Opportunities: Rebooting the European Financial Sector", Süddeutsche Zeitung, Finance Day, Frankfurt, http://www.ecb.europa.eu/press/key/date/2016/html/sp160302.en.html, March.

7. Constâncio, V. (2015) Interview with Börsen-Zeitung, "We need more integration in Europe", https://www.ecb.europa.eu/press/inter/date/2015/html/sp151230.en.html, December.

8. Draghi, M. (2015) Monetary policy and structural reforms in the euro area, Prometeia40, Bologna, https://www.ecb.europa.eu/press/key/date/2015/html/sp151214.en.html, December.

9. Draghi, M. (2016) Introductory statement during the Hearing at the European Parliament's Economic and Monetary Affairs Committee, Brussels, http://www.ecb.europa.eu/press/key/date/2016/html/sp160215.en.html, February.

10. Five Presidents' Report sets out plan for strengthening Europe's Economic and Monetary Union as of 1 July 2015 (2015), Press release, Brussels, http://europa.eu/rapid/press-release_IP-15–5240_en.htm, June.

11. Hill, J. (2015) "For a financial sector that promotes investment", London, http://europa.eu/rapid/press-release_SPEECH-15–5380_en.htm, July.

12. Hill, J. (2015) Keynote speech at European Banking Federation, "A Brave New World for Banks", 2015 Annual High Level Conference, Brussels, http://europa.eu/rapid/press-release_SPEECH-15–5624_en.htm, September.

13. Hill, J. (2015) Speech at the European Central Bank Forum on Banking Supervision, “Bank Supervision: Europe in global context”, Frankfurt, http://europa.eu/rapid/press-release_SPEECH-15–5985_en.htm, November.

14. Hill, J. (2015) Opening statement on Structured Dialogue – European Parliament: Economic & Monetary Affairs Committee, Brussels, http://europa.eu/rapid/press-release_SPEECH-15–6206_en.htm, November.

15. Hill, J. (2015) Speech at the CRR Review Conference, DG FISMA, “The Impact of the CRR and CRD IV on Bank Financing of the Economy”, Brussels, http://europa.eu/rapid/press-release_SPEECH-15–6310_en.htm, December.

16. Hill, J. (2016) Keynote speech at the European Banking Authority’s 5th Anniversary Conference, London, http://europa.eu/rapid/press-release_SPEECH-16–250_en.htm, February.

17. King, M. (2016) “The End of Alchemy: Money, Banking and the Future of the Global Economy” Little, Brown.

18. Praet, P. (2015) Interview with La Libre Belgique, “Europe must show it can bring prosperity”, https://www.ecb.europa.eu/press/inter/date/2015/html/sp151221.en.html, December.