Mario Draghi: European Systemic Risk Board (welcome address)

Speech by Mr Mario Draghi, President of the European Central Bank and Chair of the European Systemic Risk Board, at the first annual conference of the ESRB, Frankfurt am Main, 22 September 2016.

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Ladies and gentlemen,

It is my pleasure to welcome you to the first annual conference of the European Systemic Risk Board (ESRB). We have a rich agenda today and tomorrow – one which reflects the value of the ESRB as an institution. The Board brings policymakers together. We have 80 member institutions, each expert in their own field. This diversity of expertise is our strength. The ESRB is uniquely placed to take a holistic view of the European financial system – to see the overarching risks and challenges that would be more difficult for our members to perceive individually.

Sharing knowledge and expertise also permits effective coordination of policy. The ESRB acts as an information hub for the implementation of macroprudential policies for banks, and as a forum to discuss these policies, including their cross-border impact and the possible need to reciprocate them in other jurisdictions.

Given its unique Union-wide, cross-sectoral perspective, the ESRB has focused its research on the challenges posed by the structure of the European financial system, and the risks and opportunities arising from ongoing changes to that structure. In that context, let me highlight two themes: the extent of overbanking in Europe and the growth of the non-bank sector.

Overbanking in Europe

Two years ago, the ESRB's Advisory Scientific Committee (ASC) published a widely cited report entitled "Is Europe overbanked?".[1] It pointed out that, over the preceding two decades, the banking sector had outgrown capital markets. In the late 1990s, the ratio of total bank assets to equity and private bond market capitalisation in Europe was below two. By 2008, this ratio had risen to four. By contrast, the comparable ratio in the US remained below one over this period, and that of Japan remained below two.

Banks play a vital role in financing small and medium sized enterprises, which are a key part of the European economy. This lending must continue to flow to productive projects if Europe is to prosper. But bank lending has a tendency to be procyclical: growing too quickly when the economy expands, and shrinking sharply when it contracts[2]. As a result, in the aftermath of a financial crisis economic growth in countries with bank-based systems lags behind that of countries with more balanced financial systems.[3]

The clear policy message is that it is better to finance the real economy through several channels rather than to rely on just one. Capital markets in particular can act as a useful "spare tyre".[4] That is why the ESRB fully supports the capital markets union, which aims to remove barriers to the development of capital markets.

Removing these barriers will foster changes in the structure of the financial system in Europe. In fact, capital markets and other non-bank sources of external finance have been growing relative to banks.[5] This growth should improve firms' access to funding, and ensure that any losses are dispersed more widely.

Low bank profitability

The overbanking in Europe, highlighted in the ASC's report, is also a factor in the currently low level of bank profitability. A number of reasons have been mooted as the causes of this low profitability, including low interest rates. Long-term real interest rates have been falling in the major advanced economies for two decades. Technological change, demographics, income inequality and safe asset scarcity are just a few of the factors exerting downward pressure on long-term real rates.[6] Accommodative monetary policy by the European Central Bank and other major central banks, acting in accordance with their price stability mandates, has also contributed to low interest rates.

Low interest rates tend to squeeze net interest margins owing to downward rigidity in banks' deposit rates.[7] But overbanking is also a factor in the current low level of bank profitability. Over-capacity in some national banking sectors, and the ensuing intensity of competition, exacerbates this squeeze on margins. Such over-capacity also means the sector does not operate at the efficient frontier, which is one reason why cost-to-income ratios remain high in some countries.

At the same time, banks benefit from revaluations in their fixed income portfolios. Moreover, profitability is boosted by a greater flow of lending and lower loan loss provisions than would have occurred in the absence of accommodative monetary policy. Analysis by the ECB suggests that these effects tend to outweigh the impact on net interest income over the short term, but the picture varies depending on banks' business models.[8] In the broader context of generalised over-capacity and technological innovation, some banks will need to review their business models to bolster profitability.

Other financial institutions also face challenges to their business models in this environment.[9] In particular, institutions providing longer-term return guarantees – notably guaranteed-return life insurers – face a future of weak profitability unless they adapt their business models to a changing world. Macroprudential policy can help to boost the collective resilience of these institutions and enhance recovery and resolution frameworks.

Systemic risks beyond banking

Let me now turn to the ESRB's focus on systemic risks beyond banking. As financial intermediation continues to shift from banks to non-banks, we need to adapt our policy framework. We need to identify migrating risks and develop tools to mitigate them.[10]

With this in mind, the ESRB published its first annual EU Shadow Banking Monitor in July.[11] The report identifies a number of areas that require close monitoring, including rising liquidity mismatches, especially among some bond funds. One measure of liquidity mismatch for open-ended funds is the share of non-liquid assets in total assets, which was 38% for bond funds in the fourth quarter of 2015, compared with 26% six years earlier. In this context, the ESRB is further analysing systemic risks posed by liquidity mismatch and leverage in investment funds.

Moreover, the report identifies considerable interconnectedness between banks and shadow banks, particularly money market funds (MMFs). Approximately two-thirds of MMFs' total assets are related to banks, mainly in the form of debt securities. This interconnectedness was a key consideration underpinning the ESRB's recommendation that MMFs should have a fluctuating net asset value, rather than promising a constant one, and that they should be subject to enhanced disclosure and liquidity requirements.[12]

Macroprudential policy beyond banking

More generally, the ESRB is analysing connections across different sectors and geographies of the financial system. This cross-cutting analysis informs the development and calibration of macroprudential policy beyond banking. In this way, targeted research enhances the quality of policymaking and thereby improves the resilience of the financial system.

The ESRB believes that the smooth functioning and systemic resilience of derivatives markets can be improved by requiring standardised over-the-counter contracts to be centrally cleared and traded on exchanges or electronic trading platforms, in line with the commitments made by the G20 in 2009. The EU's first central clearing obligation came into effect in June this year for certain interest rate derivatives, and will gradually be extended to other transactions. The ESRB is monitoring the effects of this obligation on collateral demand and network structure, and will publish its findings in due course.[13]

The ESRB is also leading research into new macroprudential instruments beyond banking. One policy under consideration is the macroprudential use of margin and haircut requirements.[14] Setting margins and haircuts in a conservative or countercyclical manner may help to contain the excessive build-up of leverage. In addition to "leaning against the wind", margin and haircut requirements can also improve financial stability by mitigating illiquidity spirals.[15] This is particularly important given that an imbalance between the demand for and supply of liquidity could amplify or transmit shocks through the financial system.

Conclusion

Let me conclude.

Since the ESRB's foundation, Europe has strengthened its regulatory, supervisory, and crisis management frameworks. The ESRB has contributed to building a rich set of macroprudential policy tools for banks,[16] and continues to coordinate the calibration of those policies. The European financial system has thus become more resilient, with greater loss-absorbing capacity.

The financial system is also adaptive. Its adaptability is a strength, helping it to meet the challenges of the current environment. But it also means that policymakers must remain vigilant. The need for vigilance is why the ESRB has always warned against policy inaction bias. Macroprudential policy is still in its formative years, and policymakers are understandably cautious about deploying novel instruments. But when we see systemic risks, we should act. Greater risk arises from inaction.

So as you listen to the presentations at this conference, think about the implications for macroprudential policy in a changing world. Is the macroprudential policy stance appropriate? Are the tools at our disposal effective? Your thoughts and comments will reflect the unique value-added of the ESRB: to bring policymakers together to exchange expertise and coordinate policy action, with the common aim of reducing the risk of financial crisis.

On that note, I am pleased to open this first annual conference of the European Systemic Risk Board.

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1 Pagano, M., S. Langfield, V. Acharya, A. Boot, M. Brunnermeier, C. Buch, M. Hellwig, A. Sapir, I. van den Burg (2014), "Is Europe overbanked?" ESRB Advisory Scientific Committee Report no.4.

2 Becker, B. and V. Ivashina (2014), "Cyclicality of credit supply: firm level evidence", *Journal of Monetary Economics*, 62: 76–93.

3 Langfield, S. and M. Pagano (2016), "Bank bias in Europe: Effects on systemic risk and growth", *Economic Policy*, 31(85): 51–106.

4 Levine, R., C. Lin and W. Xie (2016), "Spare tire? Stock markets, banking crises, and economic recoveries", *Journal of Financial Economics*, 120(1): 81–101.

5 European Central Bank (2015), "Report on financial structures", October.

6 Summers, L., "US economic prospects: Secular stagnation, hysteresis, and the zero lower bound", *Business*

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[7] For an analysis of the sensitivity of US banks' pre-provision income over one year to changes in short-term interest rates, see M. Gomez, A. Landier, D. Sraer and D. Thesmar (2016), "Banks' exposure to interest rate risk and the transmission of monetary policy", ESRB Working Paper no.13.

[8] Cœuré, B. (2016), "Assessing the implications of negative interest rates", speech at the Yale Financial Crisis Forum, Yale School of Management, July.

[9] These challenges are set out in more detail in an ESRB report on the macroprudential issues arising from low interest rates and structural change in the EU financial system.

[10] European Systemic Risk Board (2016), "Macroprudential policy beyond banking: an ESRB strategy paper", July.

[11] European Systemic Risk Board (2016), "EU Shadow Banking Monitor", July. The methodological background to the ESRB's EU Shadow Banking Monitor is described in: L. Grillet-Aubert, J. Haquin, C. Jackson, N. Killeen and C. Weistroffer (2016), "Assessing shadow banking – non-bank financial intermediation in Europe", ESRB Occasional Paper no.10.

[12] European Systemic Risk Board (2012), "Recommendation on money market funds", December. Further analysis of money market funds' systemic importance is provided in J. Ansidei, E. Bengtsson, D. Frison and G. Ward (2012), "Money market funds in Europe and financial stability", ESRB Occasional Paper no. 1.

[13] Abad, J., I. Aldasoro, C. Aymanns, M. D'Errico, L. Fache Rousová, P. Hoffmann, S. Langfield, M. Neychev, and T. Roukny (2016), "Shedding light on dark markets: First insights from the new EU-wide derivatives dataset", ESRB Occasional Paper no. 11.

[14] European Systemic Risk Board (2015), "Report on the efficiency of margining requirements to limit pro-cyclicality and the need to define additional intervention capacity in this area", July.

[15] Clerc, L., A. Giovannini, S. Langfield, T. Peltonen, R. Portes, and M. Scheicher (2016), "Indirect contagion: the policy problem", ESRB Occasional Paper no. 9.

[16] European Systemic Risk Board (2014), "Flagship report on macroprudential policy in the banking sector", March; and European Systemic Risk Board (2014), "Handbook on operationalising macroprudential policy in the banking sector", March.