Bank of Italy conference in honour of Tommaso Padoa-Schioppa

Panel remarks by Jaime Caruana

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I greatly appreciate the invitation to participate in this conference to commemorate Tommaso. I had the pleasure to work and to discuss with him for many years, and I always admired his capacity to analyse and to think looking forward. He was a man of vision and a friend whose advice we miss.

I would like to make three points in relation to Tommaso's contribution. First, he rejected the "own house in order" doctrine. Second, he stressed the importance of supervision. Finally, he underscored the limitations on our capacity to quantify risks.

In 1994, Tommaso Padoa-Schioppa and Fabrizio Saccommani[1] described the market-led global financial system as still requiring international cooperation that transcends national sovereignty in three areas: monetary policy; payment systems oversight; and banking supervision. I will structure my remarks around these three headings, with particular emphasis on the third rubric, banking supervision.

I agree with Tommaso's rejection of the "house in order" doctrine, which claims that if each national policy player keeps its house in order, then the world itself would be in order.[2] In all three areas, we are progressively recognising the need for competence and action that go beyond the self-sufficient Westphalian state, which exercises unchallenged sovereignty within its own territory.[3]

En passant, I note that Tommaso remained very much the same man as his career spanned these three areas: Deputy Director General of the Bank of Italy and member of the Executive Board of the ECB; Chairman of the Committee on Payment and Settlement Systems; and Chairman of the Basel Committee on Banking Supervision (not to mention securities supervisor, accounting standard setter and finance minister). Tommaso's vision was not bounded by any silo.

Monetary policy

In that spirit, regarding monetary policy, allow me to make three quick points:

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[1] "Managing the market-led global financial system", in Peter B Kenen (ed), *Managing the global economy*, Washington: Institute for International Economics, 1994, pp 235–68.

[2] "Interdependence and cooperation: an endangered pair?", in Claudio Borio, Gianni Toniolo and Piet Clement (eds), *Past and future of central bank cooperation*, Cambridge: Cambridge University Press, 2008, pp 211–19.

[3] "Markets and government before, during and after the 2007–20XX crisis", Per Jacobsson Lecture, Basel, 27 June 2010 (http://www.perjacobsson.org/lectures/062710.pdf).

First, taking one particular example, global liquidity developments highlight the insufficiency of the "house in order" doctrine in national monetary policy. Major currencies are extensively used outside the home jurisdiction, and so the home authorities have a direct influence on monetary conditions in the rest of the world.[4]

Second, Tommaso's far-sightedness led him to call the euro a "currency without a State",[5] which makes it a post-Westphalian project par excellence. He held that "further progress toward the construction of a political union would, over time, be critical for the potential and ultimate success of the single currency".[6] In my view, at present the euro area states are the sovereigns behind the euro.[7] Thus, further fiscal agreement is a necessary condition for a stable single currency.

Third, Tommaso held that there was a tension between a single monetary policy and national bank supervision. Let me return to this in a moment under the rubric of banking supervision.

Payment systems

Again in the spirit of Tommaso, please permit me to make two quick points about payment systems. First, in the euro area, the TARGET payment system should be recognised as one of the greatest pieces of infrastructure since the Roman aqueducts, lengths of which still stand in Europe. Nowhere else do national borders matter so little for payment flows.[8]

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4 The market-led international monetary system undid what Tommaso and Fabrizio called "the territorial correspondence between financial markets and central banks' jurisdiction". See "Global liquidity: the view from Basel", speech to the International Capital Markets Association, Paris, 25 May 2011 (http://www.bis.org/speeches/sp110526.htm). See also Claudio Borio, Robert McCauley and Patrick McGuire, "Global credit and domestic credit booms", *BIS Quarterly Review*, September 2011, pp 43–57 (www.bis.org/publ/qtrpdf/r_qt1109f.pdf). Tommaso pushed the argument to conclude that any currency managed along strictly national lines cannot serve as a satisfactory international money – what he called a "generalised Triffin problem". See "The ghost of bancor: the economic crisis and global monetary disorder", lecture, Louvain-la-Neuve, 25 February 2010. See also the Palais-Royal Initiative (a group convened by Michel Camdessus, Alexandre Lamfalussy and Tommaso Padoa-Schioppa), *The reform of the international monetary system: a cooperative approach for the twenty-first century*, 8 February 2011 (www.global-currencies.org/smi/gb/telechar/news/Rapport_Camdessus-integral.pdf).

5 First used in *The euro and politics, Internationale Politik*, German Council on Foreign Relations, transatlantic edition, 4(1), 2000; and subsequently in *The euro and its central bank: getting united after union*, Cambridge: MIT Press, 2004, p 35. See also Otmar Issing, "The euro – a currency without a state", Helsinki, 24 March 2006 (www.ecb.int/press/key/date/2006/html/sp060324.en.html).

6 *The euro and its central bank*, op cit, p 36. Thus, Tommaso understood the deep historical connection between the state and money, as opposed to the ahistorical view that money developed out of private sector transaction cost minimisation. See Charles Goodhart, "The two concepts of money: implications for the analysis of optimal currency areas", *Economic Journal of Political Economy*, 1998, vol 14, pp 407–32.

7 Taking a different line, Jaap Hoeksma and Dirk Schoenmaker argue that the sovereign behind the euro is the combination of euro area states and the European Union in "The sovereign behind the euro", *Duisenberg School of Finance Policy Paper Series,* September 2011, no 15.

8 Tommaso was very closely involved in setting up an EU-wide system for making large-value payments, as it was then described. See *The euro and its central bank: getting united after union*, Cambridge: MIT Press, 2004, pp 130–34.

Second, CLS Bank, a result of international cooperation, has done what no single nation could do in taking settlement risk out of the currency market. Now payment against payment for most currency exchanges spans the time zone gaps that are as old as the planet.[9]

Banking supervision

Finally, I turn to my subject proper, banking supervision. Two recent changes in the Basel Committee deserve attention. The Basel Committee was enlarged in 2009 to recognise the resulting breadth of interest, including the G20 countries. And, more fundamentally, global banking supervision has made additional progress in recognising the limitation of the "own house in order" doctrine.

Regulation and supervision beyond the "own house in order" doctrine

Stefan Ingves, the Basel Committee Chairman, has said: "Setting rules without ensuring their implementation is akin to building a lighthouse without ever switching the light on."[10] Peer review has become a new additional approach to ensure consistent implementation.

Accordingly, the Basel Committee will monitor the implementation of Basel III. In particular, its Standards Implementation Group will assess members' progress in adopting the Basel standards and draw attention to any lack of progress. In addition, the Committee will assess the consistency of its members' national or regional regulations with the globally agreed Basel III rules, disclosing the results of off-site and on-site assessments. Finally, the Committee will assess whether the rules are delivering comparable outcomes across banks. In particular, the Committee will test whether risk weightings for assets are similar (for similar exposures) in various jurisdictions.

In performing reviews of implementation, the Committee is shifting significantly from its previous practice and culture. The Committee will now take its assessments to the doorsteps of banks or supervisors.

In Tommaso's terms, all this carries the practice of banking supervision further away from the Westphalian model of national sovereignty. Precisely because banking strains do not respect borders, banking supervisors must work together across borders.

Within Europe, Tommaso argued, and subsequent events have strongly confirmed, that there the introduction of the euro led to an unsatisfactory mismatch between a single monetary policy and integrated financial markets, on the one hand, and national bank supervision, on the other.[11] I am sure Andrea Eria will address this European perspective.

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9 Committee on Payment and Settlement Systems (CPSS), *Progress in reducing foreign exchange settlement risk*, May 2008 (http://www.bis.org/publ/cpss83.pdf). Admittedly, Tommaso would have preferred a central bank-run settlement utility; see the central bank "common agent" option as described in the Noël Report: CPSS, *Central bank payment and settlement services with respect to cross-border and multi-currency transactions*, September 1993, pp 24–25 (bis.org/publ/cpss07.htm).

10 Stefan Ingves, "Talk is cheap – putting policies into practice", speech to the conference on *Strengthening financial sector supervision and regulatory priorities in the Americas*, San Francisco, California, 16 November 2011 (http://www.bis.org/speeches/sp111116.pdf).

11 "Central banks and financial stability: exploring a land in between", policy panel introductory paper presented at the Second ECB Central Banking Conference on *The transformation of the European financial system*, Frankfurt, 24–25 October 2002.

Importance of supervision in addition to regulation

In his Per Jacobsson Lecture, Tommaso emphasised the importance of supervision in addition to regulation. He said: "[G]overnment was captured by the myth that finance can regulate and correct itself spontaneously and hence retreated too much from the regulatory and supervisory role that is necessary to ensure stability. […] [S]upervision, not regulation, was the main problem. Stronger enforcement of the existing rules [supervision] would have sufficed to avoid the disaster."[12] It is evident that the same rules produced different results in North America and in Europe, in part owing to differences in supervision. Moreover, the light touch proved not to be the right touch.

The main challenge remains to capture systemic risk and to internalise systemic risk. This goes beyond changes in risk management and regulations – it requires institutional changes in regulatory and supervisory frameworks. At the national and international levels, institutions responsible for macroprudential supervision must be made to work, including the European Systemic Risk Board.

In this domain, central banks have a critical role to play. I remember at a conference at the ECB Tommaso eloquently arguing that work on financial stability is in the genetic code of central banks. Tommaso was also prescient in his forecast on that occasion: "[S]ince the importance of liquidity and contagion risks is increasing, we should expect an increase in the role of central banks in financial stability. Attention should be paid to the risks stemming from non-bank financial activities and financial market price developments. [...] [C]entral banks cannot be indifferent to financial stability; a policy of benign neglect is not an option. The Eurosystem cannot be an exception to this."[13] The role assigned to the ECB in the new European Systemic Risk Board bears out Tommaso's prediction. Access to relevant information, including individual institutions' supervisory information, is critical.

Limitations on risk quantification

Tommaso spoke many times of the need to avoid a false sense of security derived from models of risk. One of the lessons that we must draw from the financial crisis is that we, the financial industry and supervisors alike, face limits in our capacity to quantify risks, particularly if incentives line up in the wrong direction.[14] We have a modest ability to internalise risks, particularly systemic risks arising from interconnections and procyclicality.

The implications of these limitations are clear. We need larger and better buffers for capital and liquidity. These buffers must be ample enough to be hit in adverse circumstances. In setting them, we must look through the cycle. They need to grow in good times so that they can be draw down in bad times.

To conclude, in all three dimensions – monetary policy, payment systems oversight and banking supervision – we acknowledge the acuity of Tommaso's insight: there is no alternative to effective, collective and supranational action.

[12] "Markets and government before, during and after the 2007–20XX crisis", op cit, pp 4 and 10.

[13] "Central banks and financial stability: exploring a land in between", op cit, pp 40–41.

[14] Jaime Caruana, "Financial stability: 10 questions and about seven answers", speech at the 50th Anniversary Symposium of the Reserve Bank of Australia, Sydney, 9 February 2010.