Jean-Claude Trichet: Financial stability

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Forum Financier Belge, Brussels, 26 November 2003.

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A. Introductory remarks

It gives me great pleasure to be here in Brussels and to address you in this very well-known forum at the kind invitation of Governor Quaden. The topic I shall be talking about today, namely "*financial stability*", is obviously very broad and challenging.

My main topic of discussion will be the probable consequences the profound changes currently taking place in the financial sector will have on financial stability and on the policies of the Eurosystem in this regard. The main reason why I am talking about this topic - and why we at the ECB are following the issue - is that the stability of the banking sector and the financial system at large is of the utmost importance for the Eurosystem, as it is for any central bank. It is the precondition for a successful conduct of monetary policy and the maintenance of smoothly functioning payment systems, which are major responsibilities of a central bank.

I would like to focus on *three specific developments*: the increasing importance of financial markets in general and market volatility more specifically, financial innovation, and the process in hand to increase the integration of financial systems across countries.

When thinking about the major challenges for maintaining financial stability I find it useful to first look at the notion of how the "real world" deviates from the "frictionless" ideal world of academic textbooks. In order to organise my reasoning, this can serve as a useful starting point, since in the ideal world there is no such thing as financial instability. Indeed, most of the concerns over financial stability actually stem from the fact that our "real world" financial markets have frictions or - in other words - *market imperfections*.

A fundamental friction is that financial market participants very often have *imperfect information*. When information is not perfect - or when markets are not fully transparent - investors' decisions may be constantly subject to reassessment, which can lead to inevitable volatility in market prices. This does not necessarily mean that there is an inherent threat to financial stability. On the contrary, the very existence of some level of volatility indicates that markets are serving the function they are supposed to deliver - that they are an efficient exchange mechanism among economic agents. Nevertheless, some recent episodes of extreme volatility have drawn our attention to more accurately delineating the boundary between "normal" and what could be called "harmful" volatility.

The second source of friction is that we also fall short of the ideal of having *complete markets*. Through the rapidly evolving process of financial innovation, new instruments - and often entirely new markets - are being created, taking us towards more complete markets and providing remedies for the shortcomings of more traditional instruments and markets. While this process clearly increases the efficiency of the financial system, some new risks may also be created along the way. A major recent example is the emergence of instruments to transfer credit risks between banks and other financial institutions. This is changing the activities and risk profiles of financial institutions, as previously credit risks were largely confined to banks.

One could consider that a third friction is that we lack *an international framework for crisis prevention and resolution*. Owing to the fact that supranational governments and judicial systems do not exist, national autonomy causes problems when it comes to practical implementation, possibly hindering a resolution of crises on a global scale. As financial systems inevitably become more integrated, risks stemming from the potential lack of a common framework increase accordingly. Substantial coordination efforts are being made by the international community to overcome this friction.

Here in Europe we have a unique situation, as we have gone further than any other region in terms of integration across national borders. Indeed, financial stability is increasingly a European, rather than national, concept. In particular, the single currency, the European System of Central Banks and single market for liquid reserves - the money market in euro - are creating a much more interconnected European financial system than is usually acknowledged. Consequently, cooperation efforts are being made by central banks and supervisory authorities to overcome the problems caused by the fact that supervision and oversight primarily remain a national responsibility.

The ECB - and the Eurosystem as a whole - is also enhancing its activities in the field of European financial stability. One part of these activities is visible through the regular articles and reports. Many other activities are less visible and take the form of discussions concerning financial stability in the ECB Governing and General Councils and ESCB Banking Supervision Committee, or our regular contribution to the strengthening of cooperation among relevant European authorities and our participation in international discussions.

I would like to organise the rest of my remarks around the three themes I have identified. First, I will look at what evidence is provided by past crises about the severity of the market frictions. Second, I would like to discuss the changes in the policy framework which have been made and, third, are being made in order to preserve financial stability.

B. The three themes and financial stability

Past crises could give us some hints about what could also be important financial stability concerns in the future. One should not go too far back as the financial system is rapidly changing and one must always be prepared for surprises. Often the new crises come as complete surprises.

B.1 The growing role of financial markets and volatility

Let me turn to my first theme - the growing role of markets. This development means that financial stability threats could increasingly stem from financial market problems. As I alluded to earlier, sudden and extreme shifts in expectations concerning the value of an asset and *increased volatility* could represent one major type of financial instability.

In Europe, most historical periods of financial instability have been linked to traditional loan losses by banks. However, if one looks at the longer-term perspective over the past 15 years or so, European financial markets have grown very rapidly. No doubt, the recourse to market-based finance in Europe is still significantly below that of the United States, but the gap seems to be rapidly narrowing. As the markets have grown and have become more liquid - thanks also to the euro - investors have been moving from bank deposits to direct and collective securities investments.

Whereas sharp and large price adjustments may not necessarily have systemic implications, financial institutions with *leveraged market positions* may be directly affected. The Russian crisis of August 1998 illustrates the point well, as mature markets experienced spillover effects through investors' leveraged positions in Russia and other emerging markets. One such leveraged exposure was held by the LTCM hedge fund. Prior to the rescue undertaken by private banks and aided by the US Federal Reserve, liquidity plunged and prices in many markets dropped to very low levels. An additional element threatening the stability of the global financial system was that virtually all of the leveraged Treasury bond investors had similar positions, including major financial institutions.

Banks' direct exposures may be an important aspect of financial instability in periods of financial market volatility. In addition, banks may hold significant exposures with non-bank financial institutions, which themselves suffer from direct market exposures. The Barings crisis in 1995 is an example of the first case, while the LTCM case is an example of the second.

In my view, the eventual scale of a systemic crisis might depend on the magnitude of the deviation of asset prices from fundamentals. How, then, do *asset price bubbles* get created in the first place? They may be created or exacerbated by some form of herding and overly buoyant investor expectations, as groups of investors imitate leading institutions' strategies. Bubbles may be further boosted by a lack of adequate disclosure, problems of conflicts of interest, and destabilising trading or investment strategies.

Once bubbles burst, portfolio insurance strategies in the event of falling prices - or dynamic hedging - might heighten the downward spiral. Particularly in earlier episodes of equity-driven financial instability, such as the 1987 stock exchange crash, the initial wave of the sale of equity futures appears to have resulted in an accelerated decline in stock prices. However, the jury is still out on the role of tools such as portfolio insurance or automatic trading rules in exacerbating aggregate financial risk.

Less controversial seems to be the observation that downward spirals in prices can be magnified by the institutions involved in the selling wave of the crash, thereby generating contagion across markets and countries. In particular, the Russian and LTCM crises demonstrate the important role of *market liquidity* as a potential channel of crisis contagion, as market price falls due to liquidity withdrawals could cause losses for many market participants.

To summarise the lessons learnt from past experiences, it seems that volatility is in itself not necessarily a threat to financial stability. Other elements are necessary before serious concerns arise over financial stability. One of the key elements is the risk faced by banks and other financial institutions, because this could be the channel through which the functioning of the financial system as a whole could be jeopardised. This view is supported by the recent episodes of market volatility in late 2002 and early 2003, when the sequence of substantial market readjustment was generally managed in an orderly manner by financial institutions across the globe.

B.2 Progressing financial innovation

Let me turn to the second theme - the implications of progressing *financial innovation*. In fact, the reason why the latest episode of stock market adjustments did not cause systemic problems could be attributed to the contribution of financial innovation to the more even distribution of risks. However, some concerns have emerged regarding the securitisation and credit risk transfer markets, for instance. From the perspective of the public authorities, concerns have been expressed in particular about the lack of transparency on the identity of the ultimate risk holders and about adequate risk management by the institutions dealing with these instruments.

In particular, financial innovations may be subject to problems when their behaviour has not yet been tested in difficult market conditions. As for any new instruments, probability analysis on the basis of historical data cannot be used for the credit risk transfer instruments that have been around for a few years only, and, thus, an accurate pricing of risk is not always possible. Inadequate data was already a problem in the use of Value-at-Risk models for risk management purposes by hedge funds prior to the Russian and LTCM crises. This kind of experience could reflect a lack of full understanding by market participants of the nature of the risks they face.

Turning back to the *credit risk transfer instruments*, these instruments allow banks to sell their credit risks, and in so doing the risk profiles of other financial institutions, particularly insurance companies, are also transformed. Hence, a major outcome of the financial innovation process is the transformation of the traditional risks faced by financial institutions.

These developments also affect the *effective supervision* of financial institutions, as it is increasingly more difficult to obtain adequate information to monitor the complex and possibly fast-changing risk positions. The financial innovation process has, indeed, necessitated the revision of the traditional supervisory approach concerning banks and other financial institutions. It has also made it imperative to ensure that the risk management systems of the financial institutions themselves are able to handle the complexity of their activities.

B.3 Integration of European and global financial markets

I would now like to turn to the last of my three themes. The *increasing integration* of national financial systems poses particular issues for the European Union and the euro area where integration is fairly advanced, although not fully complete. Integration and increasing international financing flows are also very much a global issue. Recently, in particular, some *emerging market crises* have had at least a potential for major spillover effects.

These financial stability risks may also be related to the growing complexity of the financing of emerging countries and the related *coordination problems*. With many more parties and instruments involved, it is inevitable that coordination is becoming a much more pressing problem than in the past, when a small number of major banks from the industrialised countries could come to an agreement with the issuer on the terms of repayment. With more sophisticated funding structures and the increasing use of debt securities, equality among creditors also becomes a more complex issue at times of debt restructuring.

C. Policy framework aimed at preserving financial stability

Let me now look at *policy responses* to the issues raised by the market developments I have just described. The structure of this policy discussion will be based around three themes: the importance of transparency in order to overcome information-related problems, reactions to financial innovation and, lastly, increasing integration and potential international spillovers of crises.

C.1 Responses to the lack of information

The information imperfections illustrated by recent episodes of market turmoil notably include incomplete and disparate *published information* by firms traded on the markets. I see key challenges in harmonising and improving the availability of information. The ultimate objective is to allow for rational investment decisions and a correct pricing of risk. Much has been done at global level and by the EU Financial Services Action Plan to increase the degree of transparency supporting the working of financial markets. This action has intensified since the high-level corporate failures in the United States, which demonstrated that there is ample scope for misleading investors through the manipulation of accounts and the information disclosed.

Maybe the most eye-catching reform - and a key challenge for companies and banks in particular - is the introduction of *new accounting standards*. The International Accounting Standard Board and the Federal Accounting Standard Board are both constantly trying to improve and harmonise these frameworks on both sides of the Atlantic. Indeed, harmonised and high quality accounting standards could make a significant contribution to the integration and efficiency of financial markets, and these could also help in Europe where the differences in accounting rules could affect the cross-country comparability of firms' accounting information.

In Europe, the reform of IAS 32 and 39 represents an attempt to improve the comprehensiveness of banks' disclosure requirements. In recent years, banks' risk exposure has shifted to instruments that have, up to now, not been reported as assets. What is maybe most important is the increased reliance of financial institutions on derivatives contracts, which has resulted in growing disparities between the information contained in financial statements and the true risk profiles of the reporting entities. The new accounting standards to be finalised next year will introduce a definition of financial instruments. They will also cover derivative instruments, which will have to be reported on balance sheets. As a consequence, information quality and coherence will be improved, providing a more accurate reflection of the new financial environment.

However, the framework that is emerging is still far from satisfactory. The revised accounting standards will most likely include an *option* for banks to measure any financial asset or liability at fair value. This means that instruments for which a market price is not available could also be valued on the basis of an estimate of a fair value. Several serious concerns arise from this approach. Comparability of financial statements could be affected, as the same transaction could be carried out at different values by competing financial institutions. Moreover, if the reliability of the valuation of non-traded assets is limited, the quality of the information contained in financial statements is going to deteriorate, thus allowing imbalances to build up without the possibility of activating correcting mechanisms.

What concerns us most is the potential impact on *financial stability*. Empirical investigations recently conducted by the ECB suggest that the extensive use of fair value accounting could significantly increase the volatility of banks' balance sheets. Valuation effects might also reduce the ability of financial institutions to react to adverse shocks, thus enhancing pro-cyclicality. These concerns are severe and great caution is warranted in the reform of accounting standards.

More accurate and timely market information is also useful from a supervisory perspective. Supervisors are indeed relying increasingly on markets as a disciplining tool for financial institutions - thus complementing their own activities. The future role of financial markets in the supervisory toolbox is likely to increase, despite possible periods of heightened volatility in financial markets. In particular, the reform of the capital framework for banks (Basel II) will introduce market discipline as an independent pillar of the framework.

C.2 Responses to financial innovation

The process of *financial innovation* I referred to earlier poses at least two key challenges for policy-makers. First, the supervisory framework needs to be constantly updated. Second, the legislative process needs to react in an effective and timely manner to the challenges created by market developments.

As regards banks, the first Basel Capital Accord agreed in late 1988 has served its purpose well in terms of raising the capital levels of banks and making them safer. However, financial innovation, in particular the securitisation of banks' assets, has left Basel I outdated and easily circumvented. As a consequence, the need to reform the existing Accord is widely recognised and supervisors are working very hard to shape the new Accord in close consultation with the private sector.

The *Basel II Accord* is aimed at bringing the capital requirements closer to the true economic risks in banks' portfolios and at offering a wide range of options and approaches to respond to the increased complexity of financial instruments. Basel II is achieving all of this basically by relying more on banks' internal models in the supervisory process. An important by-product is, therefore, that there is a lot of pressure on banks to improve their risk management systems. Improvements are already visible. It seems clear to me that more supervisory efforts, similar to those in the banking sector, may also be needed in the other sectors of financial institutions, for example in insurance.

The ECB has drawn attention since the early stages of the Basel II process and the implementation of the framework in the EU to macro-prudential implications and to the possibility of increased *pro-cyclicality* of certain provisions. When bank capital is largely based on risk and risk increases in a recession, macroeconomic consequences might arise through a procyclical reduced ability of banks to lend. These concerns have been appropriately addressed in the revised proposals submitted for consultation by the Basel Committee and the European Commission. Pro-cyclicality concerns are substantially mitigated and a good balance can be found between risk-sensitivity and macroeconomic stability. Of course, attention will have to be paid to these aspects in terms of the implementation of the new framework as well.

C.3 Responses to further integration

Let me talk next about the challenges caused by the third development, progressing financial integration. I will first discuss some of the relevant European issues and then turn to global issues.

EU/euro area issues

In the EU there is first of all the challenge of increasing the efficiency of the complex *regulatory process* to meet the pace of innovation sustained by the markets and to increase regulatory convergence across countries in order to support integration and reduce the burden on financial institutions operating in several countries. The so-called Lamfalussy procedure - where some experience has already been gained in securities supervision - will seek to do precisely this, and will also improve the state of affairs in banking and insurance supervision.

The deepening market integration experienced in the EU has given rise to the need for enhanced supervisory cooperation and common financial stability surveillance. As regards pure, *micro-level supervisory cooperation*, cooperation is being gradually stepped up through the "Lamfalussy procedure" and the establishment of the so-called level three committees, where supervisors exchange views - the primary aim being to achieve a consistent implementation of the existing legal framework.

We need adequate cooperation between central banks and supervisory authorities as well as a safeguard in relation to *crisis prevention*. The ESCB Banking Supervision Committee has long been working as the interface between the EU central banks and banking supervisory authorities. It combines the macro-level perspective of central banks, which are best placed to monitor ongoing developments in the financial system, with the equally important micro-level approach of the supervisory authorities to provide a joint and comprehensive assessment of the stability of the EU banking sector.

Let me also note the importance of having appropriate arrangements at EU level for financial *crisis management*. Good progress has been made as a result of the recommendations of the Brouwer report. Notably, the Banking Supervision Committee has concluded a Memorandum of Understanding on cooperation and information-sharing in crisis management situations between all central banks and banking supervisors of the EU.

Global issues

At international level, examples of how effective crisis management and resolution is hindered by the absence of a *common legal framework* are well documented. However, a common legal framework is only one important element required for the orderly pursuit of international finance. Another would be a concrete enforcement mechanism, but this is possibly inconceivable in the context of sovereign states. Indeed, contractual arrangements are increasingly aimed at compensating for the lack of a common regulatory and enforcement framework.

The response of the international community to coordination problems includes efforts in crisis prevention and crisis resolution. In the context of *crisis prevention*, the promotion of international standards and codes is a promising avenue. The policy response to alleviate *crisis resolution* has covered all three aspects involved: domestic adjustment, official financing and private sector involvement. Although all three are crucial to a successful crisis resolution, let me focus here on the last.

As regards private sector involvement, several proposals have been put forward, including the *Sovereign Debt Restructuring Mechanism* (SDRM) proposed by the International Monetary Fund (IMF). This legally binding mechanism was based on the idea that some elements of bankruptcy mechanisms applicable in the domestic context to private or public sector entities could be used in a sovereign context. The idea of creating an SDRM has been put aside for the time being, mainly because of concerns over the potential adverse effect on borrowing costs.

A second proposal, supported most enthusiastically by the private sector and by a number of sovereign issuers, is based on the use of *collective action clauses* (CACs). These clauses, which facilitate coordination among creditors by creating clear rules for reaching a binding agreement over a debt restructuring proposal, would become a regular feature of all new international bond issuance. CACs have the advantage of being easily integrated into market practices and having a straightforward structure, which makes them a powerful coordination tool for creditors holding debt of the same issuance. However, their contribution to solving coordination problems at the level of the total stock of outstanding debt of a country is less clear.

Finally, a third proposal - and this is actually one I myself suggested at the IMF and World Bank annual meetings in Washington in September 2002 - currently being studied by the Group of Twenty is to have a so-called *Code of Good Conduct*, which would set out best practices and guidelines for borrowers, lenders and the international community. The Group of Twenty consists of the G7 major industrialised countries, the largest emerging market economics and also the EU presidency, ECB, IMF and the World Bank, as well as the chairpersons of the International Monetary and Financial Committee and the Development Committee.

Although these best practices would be non-binding, they could improve the process of crisis resolution. In particular, the Code would spell out general principles for all parties involved and would also offer a “toolbox” of agreed instruments and best practices to be used by interested parties depending on the circumstances. The Code would also include CACs in the set of instruments to be recommended. In the October meeting, the Group of Twenty decided to encourage a group of issuers and market participants to engage in further discussion.

D. Concluding remarks

In conclusion, the issues generated by the fast evolution of the financial system I have been speaking about today are very complex and demanding for public authorities. I hope that I have been able to demonstrate that some elements of the necessary public response are very encouraging, while others will require renewed efforts. My objective has also been to focus on European issues and to highlight the special conditions of the euro area and the role of the ECB and the Eurosystem in fostering financial stability.

Thank you very much, ladies and gentlemen, for your attention.