Guy Quaden: Efficiency and stability in an evolving financial system

Opening address by Mr Guy Quaden, Governor of the National Bank of Belgium, at the National Bank of Belgium Conference on Efficiency and Stability in an Evolving Financial System, Brussels, 17 and 18 May 2004.

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Ladies and Gentlemen,

I am pleased to welcome you at the third biannual international conference organised by the National Bank of Belgium. This year's subject is “Efficiency and Stability in an Evolving Financial System”. The topic is of the utmost importance not only to central banks but also to all economic agents. Indeed, the efficiency and stability of the financial system is a prerequisite for the optimal allocation of capital over different sectors, for adequate risk-sharing across agents and ultimately for economic growth and stability. Central banks have a particular interest in the maintenance of an efficient and resilient financial system, because it ensures the effective implementation of monetary policy and thus contributes to meeting the final objective of price stability, and to promoting high sustainable growth.

Over the past decade our financial systems have been going through major changes. Those developments raise new questions and face central banks and other bodies having supervisory and regulatory powers with new challenges. In order to provide an appropriate response to these new and changing circumstances, policymakers should have a detailed knowledge of the ongoing processes and apply adequate theoretical models and insights to support their decisions. This conference combines keynote lectures by internationally distinguished researchers with the research effort of 6 Belgian teams, 4 academic teams and 2 teams from within the Bank. A selected group of international experts, with a broad research experience in financial issues, will act as discussants of these research papers. Their comments will be the start of a discussion I would like all of you to participate in. We hope that this conference, offering central bankers, academic researchers and financial experts the opportunity to exchange ideas, will contribute to our understanding of the ongoing changes.

Major changes having taken place in our financial environment over the last five to ten years have been the introduction of the euro and European financial integration, the global financial liberalisation and the rapid development of new financial products, the consolidation in the banking industry and new technologies for producing financial services. The introduction of the euro has removed one of the main factors of financial segmentation across eurozone countries, namely the multiplicity of currencies. Thereby, it has reduced the vulnerability of the financial and real sectors to exchange rate shocks. The resulting financial integration has proved to be impressive in the securities markets. For example, the differential between interest rates in interbank markets and bond markets has narrowed drastically, cross-border bond and mutual funds holdings have been increasing very rapidly, a market for private bond issuance has developed within Europe and equity price fluctuations have been converging. These factors have induced a rapid growth of the financial markets and have facilitated the direct access of borrowers and savers to the markets. Our traditional bank-oriented financial systems are gradually turning into a mixed organisation with substitution possibilities between bank and market-based financial products. The co-existence of and the competition between the two systems for allocating financial flows and risks in the economy should enhance economic efficiency, provided appropriate regulations, monitoring and supervision create the conditions for fair competition.

Against this background, the banking sector has experienced major changes. Consolidation in the banking industry has been substantial. At the same time, banks have diversified their activities through mergers or by creating bank insurance groups. They have also been trading parts of their balance sheet assets and risks through financial markets. In addition, they have expanded their activities abroad, although further developments towards cross-border mergers and the creation of larger Europe-wide banks can be expected. So the banking sector is now characterised by higher concentration, stronger competition from foreign banks and direct competition with financial markets.

But what precisely will be the future role for banks in this new financial environment? Theory and empirical evidence support the view that, as providers of finance, banks have the advantage of being in a position to acquire information on the borrowers and to monitor them thanks to long-lasting bank-lending relationships. This mitigates the effect of asymmetric information and moral hazard problems on the provision of funds. It is especially relevant to newly set up, small and medium-sized enterprises.

This debate is not only important for banks, but for corporations themselves. Indeed, it is regularly asserted “,-in various countries, not the least in Belgium, that SME face increasing difficulties to get bank financing and that this problem could be compounded by the revised capital requirements imposed by the new Basel II agreement. I would like to emphasise two points. First, the new Basel rules take expressly into account the specificities of SME. Second, recent figures for Belgium clearly indicate that, while large corporations have recently shifted to market financing, bank loans to SME keep increasing, and, moreover, are priced to rates which compare rather favourably to the ones applied in the rest of the eurozone. In this context, it seems quite difficult to speak of a credit crunch or of a comparative hardening of credit conditions in Belgium.

Nevertheless, given the recent trend towards bank consolidation, a clear understanding of how banks succeed in combining the benefits of large-scale operations without losing the close relationships with their clients is required. These questions as to the future equilibrium between banks and financial markets will be tackled during our first session today.

These recent financial developments will have an impact on all financial tra nsactions and on the whole spectrum of financial firms. But the benefits gained from increased financial integration and efficiency will extend well beyond the financial sector. Actually, the real economy may be expected to benefit most, because a more efficient financial system implies higher expected returns for sectors with a financial surplus and lower borrowing costs for investing in new projects that need external finance. This should facilitate the re-allocation of capital towards new developing sectors and firms that have a high growth potential. The real effects of financial market liberalisation will be envisaged during the second session of our conference.

Increasing financial efficiency while maintaining financial stability is not only a major objective but also a challenging task. In order to meet this goal we should carefully design and monitor market organisation and set up appropriate regulatory and supervisory arrangements.

Recent research has shown the important role market organisation or market micro-structure plays as to the efficiency and the stability of financial markets, and more in particular as to market liquidity. Insufficient market liquidity during periods of tension may exaggerate price volatility and increase risks of contagion over markets and institutions. The availability of broad market liquidity under all circumstances is therefore crucial to reap the rewards from the expansion and the integration of financial markets. The third session in the conference will deal with these issues.

Financial services and bank management in general have become increasingly sophisticated and complex. Information technology has fostered the use of quantitative management tools to evaluate credit and market risks as well as other risks, such as liquidity and operational risks. Current banking regulations should be adjusted to take into account the specificity of bank risks. They should provide the proper incentives for financial firms to strengthen their internal control and risk management systems. The new Basel II solvency requirements for instance develop a more comprehensive and risk-sensitive approach to banks’ capital requirements and a strengthened role of market discipline.

As a member of the Basel Committee on Banking Supervision, the Bank has been deeply involved in the design of these requirements. As the new requirements will have to be endorsed by the G 10 Governors and Heads of Supervision before their publication at the end of June, I will be involved as well. Last week the Basel Committee published a press release to announce that it had achieved consensus on the remaining issues so that I don’t expect that this endorsement could still prove problematic.

The introduction of this new set of rules represents a milestone in the design of a more dynamic prudential environment, combining rules and discretion, supervisory monitoring and market discipline. This does however not mean that the work is now finished. The implementation of the new requirements will necessitate considerable efforts by the financial firms, the supervisory authorities and central banks. In order to facilitate that process the Basel Committee created an Accord Implementation Group and European supervisors decided to cooperate more closely in order to achieve a greater convergence of supervisory practices. The legal work of implementing the new requirements in EU and national legislation will also be a huge task.

It is therefore important that the closer interaction between the academic and regulator’s worlds which is one of the new features in the design of Basel II be maintained during the implementation phase. I hope that this conference will also contribute to this.

Other developments of our financial system I have mentioned before, such as the concentration process in the banking sector, the creation of financial conglomerates or bank-insurance companies and the development of cross-border activities, also call for a reassessment of our regulation mechanisms. However difficult it has proved to achieve a convergence between the national supervisory authorities in the banking sector, the next daunting challenge will most probably be, in my opinion, to enlarge that convergence to other segments of the financial system.

I would like to thank all speakers and discussants taking part in this conference. I am also grateful to the Belgian academic researchers and our own staff who have contributed to the research projects prior to this conference and, like all of you, I am looking forward to the presentations of their research results. Finally, I would like to thank all of you for your attendance here today and I trust your participation in the discussions and question time will be very active. I hope this conference will help all of us to better understand the mechanisms underlying the recent financial developments as well as the policy responses which should accompany them.