Antonio Fazio: Regulation and supervision in financial markets

Presentation by Antonio Fazio, Governor of the Bank of Italy, at the Frankfurt European Banking Congress 2004, panel discussion on "Regulation and Supervision in Financial Markets", Frankfurt, 19 November 2004.

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1. Development and integration of financial markets in the euro area

The introduction of the single currency has given a decisive impetus to financial integration in Europe.

The integration of the money market has been rendered possible by the creation of TARGET, the European payment system. The launch of the new-generation system based on a single platform is scheduled for 2007.

The euro has had a particularly significant impact on the European market for private-sector bonds; there has been a considerable increase in the number of even medium-sized firms placing issues outside their home country. The home-bias of equity portfolios has diminished.

In the main industrialized countries the medium-term growth in the quantity of money, and hence in the volume of bank deposits, is in line with that in nominal GDP.

The faster rate of expansion in the aggregate volume of financial assets, that is the process of financial deepening, is the outcome of the direct relationship established on the financial markets between the firms and the public sector issuing securities, on the one hand, and the investors purchasing them, on the other.

In Italy, between 1995 and 2003 the volume of funds raised directly on the financial markets by firms issuing shares, bonds and other instruments grew from 20 billion euros to 65 billion.

The amount of households' financial wealth consisting of corporate securities increased from 180 billion euros to 470 billion, that is from 19 to 36 per cent of GDP.

Similar developments have taken place on other markets.

The stability of the banking system, the protection of the savings it intermediates and their efficient allocation are entrusted to the banking supervisory authority, as well as to market discipline.

In order to strengthen, in this new context, the safeguards for savings invested in securities, steps must be taken to ensure more effective controls on financial markets and firms issuing securities, if necessary by forging Europe-wide links.

2. Banks and financial markets

During the 1990s the large-scale process of consolidation and consequent growth in the size of banks encouraged the spread of the universal bank, which combines retail and wholesale business and simultaneously performs both commercial and investment banking services.

The banks themselves have greatly stepped up their role in the distribution of third-party financial products, insurance policies, investment funds and corporate bonds. Credit risks and market risks have diminished with their progressive transfer away from banks' balance sheets, but other types of risks have emerged.

The reputation of a bank is inevitably and increasingly affected by the quality of the products it supplies to its customers. There has also been an increase in both legal and operational risks.

The banks' increasing role in the distribution of third parties' products makes it crucial to monitor for conflicts of interest. It is extremely important that conduct should be ethical. The integrity and completeness of the information provided to the public must be guaranteed and internal controls must be reinforced. Staff incentives must be designed to prevent the risk of improper conduct.

3. Supervision

International cooperation between banking, insurance and financial market supervisory authorities is strengthening. In view of the close links between the systems of the major areas - in the first place those of central and western Europe and the United States, but also to an increasing extent those of eastern Europe and Asia - supervisory cooperation has spread to the global level.

In Europe, the nationally based organization of banking supervision is in conformity with the cardinal principle of the single European market, founded on minimum harmonization and mutual recognition.

Supervision on a national basis permits the authorities to operate near the entities subject to control. It favours a constant exchange of information and direct contact with intermediaries. This is particularly effective if it is also realized by means of a widespread presence in the territory and through on-site inspections.

Banking supervision is rooted in the legal and administrative systems of each country, not least owing to the possible involvement of public money in crises.

Europe has equipped itself with a well-structured system of multilateral cooperation and bilateral agreements between the national authorities responsible for supervising the banking and financial markets.

Spurred by the guidelines set by the Ecofin Council meeting of Oviedo in 2002, in 2004 the application of the Lamfalussy reform was completed, extending to the banking and insurance sectors bodies and legislative procedures that had already been introduced in the securities field. The reform process sees national authorities and European institutions engaged in speeding up the approval of harmonized European regulation, ensuring its uniform application in national law and further strengthening cooperation among the supervisory authorities.

4. Derivatives

In the last four years the cyclical slowdown of the global economy, stock market turbulence, the failure of large companies operating at international level and the default of sovereign states have subjected financial systems to strong pressures in both advanced and emerging economies.

Banks have demonstrated a great capacity to absorb the destabilizing impulses. Both in Europe and in the United States, the ratio of losses on loans has been lower than that registered during the recession of the early 1990s. There have been no significant episodes of instability.

The greater soundness and flexibility of the system derive above all from the reorganization and capital strengthening of intermediaries prompted in many countries by the public authorities since the second half of the 1990s. The strong expansion of the bond market, which has allowed firms to supplement bank loans with funds raised directly from savers, has contributed to the stability of the system.

The shocks that have hit the international financial system have been absorbed thanks also to the development of the derivatives market. At the end of 2003 the notional value of over-the-counter derivatives was approximately 200 trillion dollars, nearly twice as much as at the end of 2001.

Interest rate derivatives account for about three quarters of the entire derivatives market. In the last few years credit derivatives have grown especially fast; in the middle of this year the notional value of credit default swaps was of the order of 5.4 trillion dollars.

The greater scope for managing risks has made it possible to avoid compounding the difficulties of the real economy and the international political tensions with financial instability. For these reasons as well, the recent phase of cyclical weakness has been shallower than in similar periods in the past.

The use of derivatives is not without its own risks.

In an environment characterized by abundant liquidity and low interest rates the sharp decline in volatility recorded in recent months on the financial markets of the leading countries is connected to some extent with the search for higher profitability by major international financial institutions through the purchase of high-yield instruments. Intermediaries appear to have increased the supply of derivative instruments that provide protection against possible changes in the value of financial assets, thereby lowering option prices and volatility, and to have taken on the related risks.

To forestall the potential adverse effects of the growth of derivatives markets, a high level of professionalism on the part of market participants is indispensable.

The role of regulatory authorities and central banks is of fundamental importance. Supervisory regulations and practices, accounting standards, and the information that intermediaries have to provide are continuously updated, both at national level and in the sphere of international cooperation, to keep up with the development of the markets and contain the systemic risks that are associated with the potential benefits offered by the growing use of derivatives.

5. Conclusions

Efficient intermediaries, developed financial markets, capable of channeling funds towards firms with favourable growth prospects, improve the allocation of resources and stimulate investment and saving.

But the very efficiency of the financial system, its stability depend ultimately on the strength of the real economy, on its ability to grow and compete.

The economy of the euro area is afflicted by a loss of competitiveness that reflects structural weaknesses in several fields. Productivity growth is unsatisfactory.

It is necessary to remove the factors of an institutional, legal and fiscal nature that hamper flexibility in the use of labour and capital.

In Europe the efforts to consolidate the public finances must be continued, not least so as to loosen the constraints that are holding back economic activity. The action of the Eurosystem aimed at guaranteeing price stability provides an essential condition for a firmly-based economic recovery.