Lucas Papademos: Financial integration, financial innovation and development

Opening remarks by Mr Lucas Papademos, Vice President of the European Central Bank, at the Second Symposium of the ECB-CFS Research Network on "Capital Markets and Financial Integration in Europe", Frankfurt am Main, 13 February 2008.

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I. Introduction

Welcome to the ECB for the Second Symposium of the ECB-CFS Research Network. As you may know, the word symposium was originally used to refer to a convivial discussion after a banquet or drinking party (among fellows who had gathered to "drink together" as denoted by the Greek noun sympotes). But Plato's philosophical dialogue entitled "Symposium" (written sometime after 385 BC) brought the meaning of the word closer to its contemporary use, since it involved a serious discussion on an important theme. In modern times, Wikipedia pointedly states that symposium "has come to refer to any academic conference, whether or not drinking takes place."

It is too early in the day to raise a glass to the ECB-CFS Research Network, even though we would have plenty of reasons to do so, as this symposium marks the end of the second stage of this initiative. The programme of this meeting aims at providing a synthesis of the Network's research activities over the past three years. The European Central Bank and the Centre for Financial Studies launched the ECB-CFS Research Network in April 2002 to promote research on "Capital Markets and Financial Integration in Europe". Since then, the Network has co-ordinated and stimulated top-level and policy-relevant research and has significantly contributed to our understanding of the structure and integration of the financial system in Europe and its linkages to the financial systems of the United States and Japan. During the second stage of this research initiative, which started in 2004, five research conferences were organised in Brussels, Vienna, Berlin, Madrid and Dublin. At these events, always hosted by a Eurosystem central bank, leading European and US academics and practitioners in the field of finance came together to address the main research priorities of the network which included a broad array of themes: bank competition, international portfolio choices, European bond markets, European securities settlement systems, and new European markets.

This second symposium will deal with a fairly wide range of topics concerning the role of financial markets in determining economic performance, in particular the economy's efficiency and stability. A closer inspection of the programme shows that the topics to be addressed are related to two processes that have affected the functioning of the financial system and its impact on the economy: first, financial integration, and second, financial innovation and development.

During the first day, the focus is on the increasing financial integration both globally and in Europe: its measurement, its determinants, its effects on the real economy – notably productivity growth, capital accumulation, income divergence – and its impact on the lending practices of financial institutions. The policy implications of European financial integration for supervisory structures will be addressed by the panel at the end of the first day.

During the second day, we will concentrate on issues pertaining to financial development and innovation, including the role of institutions and legal frameworks, the contribution of venture capital and private equity, and the broader effects of financial innovation on economic performance. The consequences of highly developed and sophisticated financial systems for the distribution of risk will be the subject of discussion in the second panel tomorrow.

II. Financial integration, financial innovation and economic performance

Let me now briefly raise a few issues concerning the role of financial integration and financial innovation in influencing the economy's performance. I will do so from a policy-maker's point of view and in the light of the ongoing market adjustment. I will suggest some areas where research can provide useful pertinent analysis. Over the past decade, a growing volume of research has examined some of these issues, but there is still a lot to learn about the mechanisms through which increasing financial integration and continuous financial innovation have been affecting the efficiency and stability of our economies, as well as about their potential impact on the conduct of monetary policy and the performance of supervisory and financial stability tasks.

There is little doubt in my mind – and economic research provides solid theoretical arguments and ample empirical support – that both financial integration and financial innovation have beneficial effects for the efficiency of both financial and real markets. Accordingly, they have affected positively long-term economic growth and have contributed to the moderation of aggregate output volatility. The findings of some of this research are included in the "Handbook of European Financial Markets and Institutions", to be released tomorrow in the context of this symposium.

What about the potential impact of financial integration and innovation on the stability of the financial system and, more generally, on macroeconomic stability? Conceptually, the analysis of this question is less straightforward and the answers given have been either ambiguous or nuanced. Moreover, developments since the summer of 2007 and the ongoing market adjustment have highlighted the role of financial integration and innovation in the propagation and – in certain cases – the amplification of shocks and have raised questions about their overall contribution to financial stability and macroeconomic volatility. So what answer can we give to the question I raised and what are the policy implications?

At a theoretical level, the impact of financial integration and innovation on stability could be ambiguous. The main effects of these processes, such as improved risk-distribution and risk-sharing, should reinforce stability; but they also involve mechanisms and effects that might amplify instability, for instance by increasing the probability of contagion. However, these latter effects cannot be looked independently of the influence of other factors, such as the prevailing risk management practices, or the incentives embedded in the business models of banks and other financial market participants that have a bearing on the distribution, accumulation and containment of risks in the financial system.

The key issue – which is not only of academic interest, but also of policy relevance and of a sensitive political nature – is this: are the processes of financial integration and innovation to be blamed, at least in part, for the recent market volatility? Or other factors or elements of the financial system are the main culprits because they have helped build up the imbalances, triggered the turmoil, contributed to the amplification of shocks and account for the uncertainty surrounding the likely duration and magnitude of the adjustment process.

The underlying causes and other contributing factors to the financial market turmoil have been analysed and discussed extensively by policy-makers and market participants. Recently, the Financial Stability Forum (FSF) submitted an interim report to the G7 Financial Ministers and Central Bank Governors which includes an analysis of the causes of the recent events and of weaknesses in the functioning of the financial system that have been revealed by the market turmoil. It is useful to distinguish between, on the one hand, general and underlying factors that have contributed to the emergence of imbalances and the accumulation of risk exposures and, on the other hand, specific factors and system features that played a role in this process and which triggered the turmoil and amplified its effects. The general and underlying causes include the exceptionally benign macroeconomic, financial and monetary conditions over the past four years – until the summer of 2007 – that had contributed to reducing risk aversion and market volatility and had fostered a "search for yield" and rising leverage. Financial innovation also played a role because the unprecedented growth of the securitisation of bank loans, of credit risk transfer (CRT) instruments and of complex structured finance products resulted in the distribution of risks and the creation of risk exposures that could not be managed effectively by financial institutions and other market participants. And the international integration of financial markets and the repackaging and transfer of credit risk made possible by financial innovation partly explain how the shock to a relatively small segment of the US financial market spread globally across borders and across other markets.

But this is only part of the story, because a number of other factors played a crucial role in triggering the turmoil and in propagating and amplifying its effects. Let me emphasise five such contributing factors or weaknesses in the financial system from a larger list:

- First, inadequate risk assessment and management, especially of funding liquidity risk, concentration risk, the risk embedded in complex structured finance products, and the risks associated with the off-balance sheet exposures of banks.
- Second, shortcomings and uncertainties in the valuation of structured finance products, due to their complexity, imperfect information about the underlying asset characteristics and excessive reliance on the ratings of such products by credit rating agencies.
- Third, distorted incentives that, inter alia, adversely affected the implementation of the “originate and distribute” model by banks and other market participants in the chain of origination, distribution and acquisition of credit risks;
- Fourth, the emergence of new financial entities – the off-balance sheet conduits and structured investment vehicles – which were sponsored by banks and which were characterised by excessive leverage and maturity mismatches on their balance sheets, because they held illiquid structured finance products and financed them by issuing short-term asset-backed commercial paper;
- Fifth, and last on my list, imperfect information about the quality and performance of underlying assets, inadequate transparency about the characteristics and risks of structured finance products and insufficient disclosure about the risk exposures of financial institutions as a result of their on- and off-balance sheet holdings.

This list of other contributing factors and system weaknesses – and it is not an exhaustive list – shows that it was not the processes of financial integration and innovation per se that were responsible for the market turmoil. Other specific factors such as inadequate risk management, valuation problems and uncertainties, distorted incentives, imperfect information, insufficient transparency and disclosure played a crucial role in the propagation and amplification of shocks. Put differently, the rapid advances in financial innovation and integration had not been accompanied by adequate appreciation of risk, effective risk management and sufficient market discipline. The turmoil partly reflects this divergence between financial innovation and integration, on the one hand, and effective risk management and sufficient market discipline, on the other. Needless to say, this gap should be bridged, but in an appropriate manner.

III. Policy initiatives to strengthen the resilience of the financial system

Significant steps have been taken and several initiatives are underway to address the identified weaknesses. And the G7 Finance Ministers and Central Bank Governors agreed on a number of key issues that be tackled. The FSF, building on the work programmes of international bodies and national authorities, will make concrete and specific recommendations on actions to strengthen the resilience of the financial system. In the light of my previous remarks, the actions of market participants and policy-makers should aim, among other things, at:

- Improvements in transparency and disclosure practices, notably disclosures by financial institutions of the valuation of their structured finance products and of their losses; disclosures of off-balance sheet risks; disclosures of risks embedded in structured finance products.
- Enhancements of risk management practices and internal control systems
- Ensuring appropriate incentive structures and addressing the revealed shortcomings in the implementation of the "originate and distribute" model;

The necessary actions should be taken by financial institutions and other market participants that have clear incentives to improve confidence and restore the normal functioning of markets. The authorities should provide both encouragement and appropriate guidance and monitor developments closely. The full implementation of the Basel II capital adequacy framework will help to improve risk management and transparency. Ultimately, the authorities will have to decide whether and where greater guidance and more specific prescription will be required to ensure appropriate incentive structures, adequate risk management and sufficient transparency. The general objective of the actions of market participants and policy-makers should be to strengthen the resilience of the financial system and safeguard its stability in order to preserve the benefits of financial integration and innovation for the economy's efficiency and dynamism and its long-term growth.

IV. The contribution of research

The appropriate actions to be taken by market participants and policy-makers to strengthen the resilience of the financial system and to safeguard its stability are numerous and challenging. In this effort, economic research can make an important contribution. Significant progress has already been made in enhancing our knowledge about the implications of financial integration and innovation for economic performance. And this symposium offers an opportunity to present and discuss a number of recent advances. Yet, the financial market turmoil has shown that the world – our economies and financial systems – is more complex and more interdependent; that underlying factors, processes, risks and vulnerabilities can interact in a ways that have not been previously envisaged. It is, therefore, essential to pursue specific research topics and to bring the various strands of work more closely together. This symposium with its varied programme provides a great forum for advancing this objective.

With regard to the policy issues I previously highlighted, it would seem to be particularly useful if economic research could further contribute in four specific areas:

- the development of models and indicators that help identify growing financial imbalances and emerging vulnerabilities and provide early warning signals;
- the analysis and improvement of incentive structures, especially those associated with the various stages of the securitisation process;
- the construction of effective models for stress-testing of tail and correlated risks, including funding liquidity risk, as well as more realistic models for macro stress-testing;
- the further elaboration of the interactions between the real economy and the financial system, with greater emphasis on the role of financial frictions, the determination of risk, and their effects for the dynamic and stochastic properties of the economy.

This list of research topics is not complete, but it is policy-relevant and analytically challenging.

In conclusion, I would like to make one final and general point. In pursuing a research agenda, it is important to maintain a broad perspective – to keep in mind and look at the "big picture" – as defined by the main policy objectives and key policy functions and by the interconnections of ongoing processes, such as financial integration and innovation, and their implications for economic performance and the attainment of the policy goals of efficiency and stability. Precisely because these interconnections and effects are complex, manifold and evolving, a deeper understanding of the fundamental processes is essential. This Network, with its theoretical contributions and empirical analysis, can undoubtedly provide valuable and highly appreciated input into the deliberations and decisions of policy-makers.

I wish you all the best and an enriching and successful symposium.

Thank you very much for your attention.