Jean-Claude Trichet: Remarks on the future of European financial regulation and supervision

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the Committee of European Securities Regulators (CESR), Paris, 23 February 2009.

* * *

Good morning ladies and gentlemen,

I would like to thank Eddy Wymeersch for inviting me to deliver a keynote address at this conference on the future of European financial regulation and supervision, with a special focus on securities markets.

Let me begin by describing current conditions in the financial sector, and the "lines of defence" that central banks and governments have established in an effort to combat systemic risks and to restore market confidence. In this context, I would like to highlight the crucial role that market participants need to play. Next, I will examine ways of reinforcing the resilience of the financial system. This is an issue that I hope you will be exploring in depth today. Finally, I will comment on the current debate about the EU's supervisory framework. A change in this framework has in my view the potential to bring about a substantial improvement in our handling of the banking sector in Europe.

I. The current situation and the policy response

First of all, let me say a few words about the situation we are facing now and the policy responses.

The financial system of the euro area, like those of the other industrialised economies around the globe, is under severe strain. This is not news to anyone here. But what has become increasingly clear since the intensification of the crisis in mid-September last year is that the strains in the financial sector are spilling over into the real economy. This has set in motion a process of negative feedback between the financial sector and the real economy. The financial system is hampering economic recovery and, at the same time, the recession is putting greater pressure on the financial system. This situation is more difficult to combat than if the problems had remained largely confined to the financial sector.

Net credit flows in the euro area remained positive during most of the financial turbulence, which has already lasted more than a year and a half. But in recent weeks we have seen the first signs of falling credit flows. Certainly, an important part of this fall is demand driven: firms have been postponing investment, reflecting the weakening economic outlook, and also households have cut back on borrowing for the same reason. However, there are indications that falling credit flows reflect also supply-side factors and tight financing conditions associated with a phenomenon of deleveraging. It is here that we have to closely watch developments. If such behaviour became widespread across the banking system, it would undermine the raison d'être of the system as a whole.

But there are more positive some elements as far as the financing of the corporate sector is concerned. One of them is given by the corporate bond market, where issue volumes have remained significant. In January, euro non-financial corporate issuance even reached a record high. Hence, this channel is open, and it is functioning. Of course, not all firms are benefiting equally from it, the pricing has become tougher and high volumes are likely to be partially compensating for more difficult bank financing. But in an environment where we

need to search for factors of reassurance, the considerable issuance volumes in the corporate bond market are noteworthy.

Overall, however, there is no doubt that the situation in the financial sector and real economy remains very difficult. How are central banks, governments and other authorities responding to these challenges? And what more should they consider doing?

The acute market conditions of last September prompted central banks to take a number of exceptional measures. These measures have been instrumental in organising a first line of defence against "systemic liquidity risk". They include increasing the size and frequency of liquidity operations, extending the list of eligible collateral, significantly expanding our balance sheets and implementing unprecedented interest rate cuts. Compared with the period before the start of the turbulence, the Eurosystem's balance sheet has grown by about €600 billion, an increase of 68%, representing just above 6% of the euro area GDP. This shows that our "intermediation role" has grown very significantly. We are now providing – and this is quite exceptional – unlimited refinancing to the banks of the euro area for maturities ranging from one week to six months in exchange for eligible collateral. This is a very important contribution to liquidity in the financial sector of the euro area.

Governments for their part have organised a second line of defence against what I have called "systemic solvency risk". Key measures have included recapitalisations, guarantees and asset support schemes. The Eurosystem has issued recommendations on the appropriate framework for both government guarantees and recapitalisation measures. The aim is to support the banking sector in a way that avoids creating distortions in the Single Market. Moreover, measures should be consistent with our liquidity management operations and they should not impair the implementation of the single monetary policy. The government measures are broadly in line with these recommendations.

More recently, discussions have focused on asset support schemes. The aim is to remove the uncertainty surrounding the valuation of certain securitised assets on banks' balance sheets. In this respect, the European Commission, in cooperation with the ECB, is defining broad guidelines for asset relief measures.

Overall, the decisions governments took in October have helped to avert a major breakdown in confidence in the banking sector. Some of the measures are still being implemented or under consideration. The success of these measures ultimately depends on the financial institutions themselves. Financial institutions have an important responsibility to use the measures made available to them by the authorities, take them fully into account in their decision-making and continue lending to the economy.

II. Strengthening the financial system

Let me now come to my second set of issues and explore ways to strengthen the financial system. Beyond the short-term need to maintain the effective intermediation function of the financial system, the crisis has highlighted substantial structural weaknesses in many areas of this system. This is where we need to rebuild and strengthen our defences. This effort should be focused on three goals: it should foster sustainability, it should strengthen resilience and it should be holistic in its reach.

1. The first goal is a financial system that is sustainable in the long term. This means correcting some of the incentives that have led to excessive short-termism. It is now clear that the promise of significant returns in the short term was often linked to a misjudgement of underlying risk. At the level of individual institutions, compensation schemes must be adjusted to avoid encouraging excessive risk-taking on the basis of relatively small amounts of capital. Instead, the incentive structure should encourage profitability over the medium to longer term. At the level of the financial system, we need to be more resolute in preventing the build-up of risks. We must strengthen financial stability assessments and develop mechanisms for translating them into

concrete measures. The ECB welcomes the proposals to reinforce macro-prudential oversight internationally. The envisaged closer cooperation between the International Monetary Fund and the Financial Stability Forum will be particularly useful.

2. The second goal is to improve our resilience to shocks. In the years leading up to the crisis, holding capital reserves or larger amounts of liquid assets, which typically earn lower returns, came to be seen as an inefficient use of shareholders' money. The underlying perspective can be compared to that in the corporate sector many years ago, when technological innovation led to the widespread introduction of the "just-in-time" model of doing business. This meant that firms held minimal inventory levels throughout the production chain. The result was a system that looked very efficient but that was very vulnerable to shocks. Something similar has happened to the financial system in recent years: the pressure to increase immediate shareholder value and short-term returns drove a number of institutions to limit their reserves and buffers to the minimum possible levels. And just as in manufacturing, the result has been a system that produced very high returns in the short term, but which proved vulnerable to shocks. Comparing the ex post returns with the considerable costs of the current turmoil, we have to realise that our financial system as a whole, including its non-regulated and non-listed entities, was neither strong nor efficient. It did not allocate capital properly, and it did not manage risks well. I have sometimes compared financial buffers with air bags in a car: what we have done in recent years is let part of the financial sector remove all the air bags. And now there has been an accident, we can see the scale of the injuries. We have to put reserves and buffers back into the system; they are the protection against serious damage in a downturn, and they are an integral part of sound finance. Such a large-scale reassessment is a matter for the medium term. In the present circumstances I wish to underline that banks should not be requested to hold more capital than is required by the existing capital framework. We should not today introduce "pro-cyclical" changes in the regulatory framework at a time when we are already observing a market-driven deleveraging of the first magnitude.

3. The third goal is reforms that are holistic in scope. In this respect, an important issue, which I'm sure will be addressed by today's conference, relates to the scope of financial regulation and prudential oversight. The current crisis is a loud and clear call to extend regulation and oversight to all systemically important institutions – notably hedge funds and credit rating agencies – as well as all systemically important markets – in particular the OTC derivatives market. What is currently under discussion is the precise way in which these elements should be integrated into an overall regulatory framework. Currently, we are in the process of identifying the regulatory gaps. This is taking place within an international discussion, which the ECB strongly supports. The ultimate aim must be to extend the regulatory net to cover all instruments, institutions and markets that are either systemically important or which play a key role for the functioning of markets. Hedge funds and credit rating agencies are at the centre of the debate. In Europe, the discussions on proposed regulatory initiatives to establish a harmonised framework for credit rating agencies and on assessing possible initiatives for hedge funds are important. The proposed regulatory framework for the registration and oversight of rating agencies – with an important role for the Committee of European Securities Supervisors and the Committee of European Banking Supervisors – goes in the right direction. I also welcome the Commission's initiative to launch a public consultation on hedge funds, to which the Eurosystem will contribute. Let me stress that both initiatives, on rating agencies and hedge funds, warrant strong international coordination. The G20, of which the ECB is a member, is setting the key milestones in this context. The outcome of this debate should be an international agreement about the key features of the new regulatory paradigm. I mentioned the OTC derivatives market; this is a prime example of a systemically important market that requires more transparency and a better infrastructure. The

ECB's Governing Council has already called for a strengthening of the infrastructure for this market in view of its systemic importance. We also support the position of ECOFIN, which in December 2008 endorsed the idea of introducing a European CCP for OTC credit default swap markets. And we see considerable merit in having this infrastructure located within the euro area.

III. The EU's supervisory framework

Let me now come to the third and last element of my reflections this morning: the supervisory framework in Europe.

Many issues are currently under consideration. I would like to focus on a dimension that is very relevant from a central banking perspective, namely macro-prudential supervision.

Macro-prudential supervision of the financial system by central banks needs to be strengthened. There is an international consensus emerging on this need, in the context of the lessons from the financial crisis.

The ECB and the Eurosystem have the technical capacity to assume a stronger role in macro-prudential supervision. Indeed, it would be a natural extension of the mandate already assigned to us by the Treaty, namely to contribute to financial stability.

The tasks of macro-prudential supervision include the monitoring and analysis of financial stability, which the ECB is already undertaking. But this goes beyond monitoring and analysis: macro-prudential supervision includes developing early warning systems for the risks in the financial system; it includes conducting macro stress-testing exercises; and it also includes an advisory role on financial regulation and supervision from a financial stability perspective.

Importantly, effective macro-prudential supervision depends on access to data and its translation into concrete measures. Access to relevant data is essential for the assessment of risks and vulnerabilities in the financial system. This is why such access must be part and parcel of a well-functioning arrangement for macro-prudential supervision. Two issues need to be considered here.

First, there is a need for a higher degree of transparency as regards the activities of financial institutions and markets that are relevant from a financial stability perspective. Supervisors and financial institutions have a role to play in enhancing transparency in their domains. To mention a specific example, we very much welcome the current dialogue between the ECB and CESR on the possibility of creating a standard for reference data on securities and issuers, with the aim of making such data available to policy-makers, regulators and the financial industry through an international public infrastructure. Such an infrastructure would enable all interested parties to produce more timely analysis of increasingly complex financial markets, especially in times of turbulence.

Second, central banks need to have access to the supervisory information that is essential for their financial stability assessments. Central banks and supervisors will also have to work together to establish an operational agreement for the information flow in both directions. This is not always straightforward in Europe given the multitude of actors involved, but here, too, current developments give us a clear mandate, even an obligation, to improve the information flow.

The ECB/Eurosystem stands ready to perform additional macro-prudential supervisory tasks. With our financial stability analysis, which has been well established over a number of years, we have already laid important foundations for such a role.

Conclusion

Let me conclude. I have mentioned the lines of defence established by central banks and governments, to safeguard, respectively, liquidity and solvency in the financial system. The reform of the regulatory and supervisory framework at the EU and international levels must substantially enhance the stability of the global financial system. The system must strengthen itself and build up its own defences. I propose a strengthening of the financial system that focuses on three goals: long-term sustainability, improved resilience and a holistic perspective.

The EU has the opportunity for an important institutional change. It can adapt the supervisory framework to the new financial landscape, reflecting the considerable increase in European financial integration that we have observed in recent years. This must be one of the key lessons for us to draw from the financial crisis. The ECB/Eurosystem stands ready to accept any additional responsibilities that the Member States may wish to assign to us, in accordance with the Treaty.

I am sure that today's conference will provide valuable insights on all these matters.

Thank you for your attention.