Gertrude Tumpel-Gugerell: The new financial architecture and the role of Europe

Speech by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the panel discussion organised by the German Office of the European Commission, Berlin, 19 May 2009.

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Introduction

I would like to thank the organisers for inviting me to this highly interesting discussion.

Since August 2007 we have been in a financial and economic crisis that has developed into one of the most severe since 1929. Although we cannot yet speak of an end to the crisis, the crisis that we are currently experiencing has made one thing very clear: the need for reform in the financial sector. While financial markets have developed rapidly in the last decades, the financial and regulatory architecture has been unable to keep pace with such developments.

The ongoing crisis has undermined the modes of operation of the private sector worldwide. Risks were undervalued and there was a lack of transparency. This has resulted in markets being faced with uncertainty and mistrust which has severely hampered market activity.

Authorities have reacted swiftly to these challenges in order to restore market confidence. Central banks around the world have stabilised markets by providing liquidity to the banking sector and have lowered policy rates to historically low levels. National governments have also demonstrated their capacity to react rapidly to exceptional circumstances and have provided support to the banking system through recapitalisation and guarantees for bank debt.

In the longer term, however, we need to improve the resilience of the financial system, so that we have better possibilities to prevent a crisis of this nature from reoccurring in the future. Therefore, the most demanding challenge is to develop long-term plans for crisis prevention and crisis resolution. For this we need above all "better" regulation and supervision, which takes account of the increasing interlinkages in the financial sector and places a greater emphasis on systemic risks.

In my remarks today, I will restrict my focus to developments in, and initiatives for, financial markets. As I am convinced that only global coordination can bring effective results in the current crisis, I will start with the global initiatives. I will then discuss the role of Europe in sculpting the future of financial markets. I will finish with some words on the possible future role of the ECB in macro-prudential supervision.

Global policy initiatives

Let me start with the global policy initiatives. The way the crisis has impacted all major economic areas has clearly demonstrated **the limits of national responses** in handling the activities of cross-border, systemically important institutions, markets and instruments. Therefore, no initiative targeting these activities can be fully effective without global coordination.

The international community has shown remarkable unity during the financial crisis. **A common understanding** on the broad response to the challenges has indeed been achieved **at the global level**. Let me name a few examples. Last year, the report by the

Financial Stability Forum (FSF) on enhancing market and institutional resilience was a key achievement that set the priorities for action.[1] The agreed principles targeted banks' capital and liquidity risk management, standards for valuation and transparency, and the role and the uses of credit ratings, in particular for structured finance instruments. The authorities were in addition called on to review their responsiveness to risks and arrangements for central banking operations in crisis situations.

Up until October 2008 the G7 had been steering the efforts to deal with the financial crisis, which was up to that time also primarily a crisis of the financial system in advanced economies. The aftermath of the Lehman Brothers' collapse saw this financial crisis spreading across the globe. In November last year, therefore, the Heads of State or Government of the G20 countries met in Washington to step up international cooperation to address the ongoing crisis. They agreed not only on urgent actions to restore global growth and stabilise financial markets, but launched a major reform agenda to strengthen financial markets and regulatory regimes so as to avoid such crises in the future.

The process continued at the recent G20 leaders' meeting in London in April this year. For example, the new Financial Stability Board (FSB), the successor to the FSF with an expanded membership, was given a mandate to provide early warnings in collaboration with the IMF. Moreover, it was agreed to extend regulation and oversight to all systemically important institutions, instruments and markets.

All this shows that many decisions have been made at the global level, many of which have already also been put into practice. For example, several international fora (such as the FSB and the Basel Committee) have been enlarged through the inclusion of new Member Countries. Moreover, the Basel II capital framework will be strengthened in a number of areas, including the treatment of securitisation activities, trading book exposures and exposures to off-balance sheet vehicles. In addition, principles for sound liquidity risk management and supervision have been published, also by the Basel Committee.[2]

It is now very important **to maintain the momentum of implementation** for the remaining issues. Let me just mention three areas that I think are of particular importance:

First, we must pay more attention to **financial stability and systemic risk considerations**; this applies particularly to the global monitoring of system stability and the supervision of cross-border systemically important institutions. For the supervision of cross-border systemically important institutions we need strong international cooperation and clear rules, in particular regarding potential burden sharing. For the global monitoring of systemic risks, the envisaged close cooperation between the International Monetary Fund and the Financial Stability Board in the conduct of early warning exercises has a crucial role to play.

Second, **the pro-cyclicality** of the financial system **must be limited**. In this regard, it will be crucial that the Financial Stability Board, the Basel Committee and other bodies develop and implement appropriate regulatory and supervisory tools to promote the build-up of reserves in good times to be used in times of stress. It will also be important to reduce the probability of individual bank's insolvencies by making appropriate provisions of capital.

And third, **regulation and oversight must be improved and expanded**. In this respect, let me particularly stress in this context that all systemically important institutions, markets and instruments should be subject to an appropriate degree of regulation and oversight. This includes in particular systemically important hedge funds, credit rating agencies and OTC

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1 "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience", published on 12 April 2008. Note that the FSF has been recently renamed the Financial Stability Board, with expanded responsibilities and membership.

2 "Principles for sound liquidity risk management and supervision", endorsed on 25 September 2008; and Consultative papers on the enhancements to the Basel II capital framework, issued on 16 January 2009.

derivatives markets, whose inclusion in the regulatory net has been already endorsed by the G20 leaders. It is only thus that we can in future prevent regulatory arbitrage between sectors and markets as well as the emergence of “shadow markets”.

The role of Europe

But let me now move to the key question of this panel discussion: What should Europe’s role be in this new financial architecture?

In my opinion, Europe has a chance to act as a **powerful force in shaping the future of financial markets, if it acts in a coordinated and cooperative manner**. I think that the first foundation stones for this have been laid. Just think of the determination that the EU leaders showed last autumn in addressing the financial crisis; together they produced a common European action plan, the **Paris Declaration**. At this very moment, important changes in the European supervisory architecture are being discussed, notably based on the recommendations of the **De Larosière Report**. These include the recommendation to transform the so-called level three committees of national supervisors into European authorities. In the field of macro-prudential supervision, moreover, a European Systemic Risk Council (ESCR) is recommended to be established, under the auspices of the ECB/ESCB.

Allow me to take a brief look at an aspect that has moved somewhat into the background of the policy debate at present. The policy initiatives should be coupled with a further striving for **financial market integration in Europe**.

History has shown that a tendency towards national retrenchment may increase in times of uncertainty. The recent crisis has indeed confirmed this. Our current measurement of the state of financial integration shows some signs of segmentation along national borders, particularly for the interbank market.[3]

It is thus important not to forget that integrated financial markets can help financial stability. They offer their participants a more efficient environment than a market divided by national borders ever could. Integrated markets are more liquid and offer better opportunities for risk diversification, and therefore reinforce the shock-absorption capacity of the system. Therefore, financial integration is directly linked to our objective of improving the resilience of markets and contributes to financial stability in the long term.

Cross-border financial risks are becoming more and more important in Europe. Therefore, while we need to remain firmly committed to financial integration in Europe, the European financial architecture, i.e. the supervisory and regulatory framework, needs to adjust to this evolution and reflect a more integrated market with more cross-border activities. Therefore, the recommendations of the De Larosière report form a good basis for discussion.

The role of the ECB

Let me turn to the ECB’s role in this regard, specifically with regard to macro-prudential supervision. What the current crisis shows us is that we must attach greater importance to systemic risks. The creation of a European Systemic Risk Council under the auspices of the ECB/ESCB – as proposed in the De Larosière report – would be an important step in the right direction.

Systemic risk is something that by nature reaches beyond the consideration of individual institutions and tries to capture interlinked risks in the financial system as a whole. This is clearly in the global public interest, and public institutions must address it. For this reason the

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[3] See the ECB report entitled “Financial Integration in Europe”, April 2009, for a preliminary analysis of the effect of the financial crisis on financial integration.

creation of the ESRC will be able to make an important contribution to financial stability in the EU and help to make a significant improvement to the present financial stability analysis at EU level. The ESRC could, in particular, noticeably improve the identification and assessment of systemic risks affecting the EU financial system by analysing the interconnections among financial institutions and markets on the basis of both macro- and micro-prudential supervisory information.

The provision of the logistical and analytical support to the ESRC by the ECB/ESCB would allow the existing knowledge and skills in monetary and financial stability analysis, which are traditional central banking activities, to be exploited. The views of the supervisory authorities could be integrated in the process by ensuring, for instance, their adequate representation in the ESRC whenever their presence is deemed useful.

But of course there are **conditions for the success** of such an undertaking, which deserve thorough consideration.

First, the effectiveness of the ESRC will crucially depend on **the access of central banks to relevant data** and information for risk assessment and monitoring of vulnerabilities in the EU financial system. The ESRC will need to rely on efficient and effective institutional mechanisms ensuring adequate information-sharing with micro-prudential supervisors and the European authorities.

Second, the risk warnings should be effectively translated into concrete recommendations on macro-prudential policies requiring follow-up actions by competent authorities. This would require adequate **mechanisms for monitoring and enforcement**. The ESRC recommendations should concern mainly supervisory action by competent supervisory authorities. They should not address either monetary policy (as this would contravene the Treaty principles) or fiscal policy (which is taken care of by existing EU economic surveillance procedures).

And third, the global dimension of the financial system and the resultant risks call for swift and comprehensive **coordination between the ESRC the IMF and the FSB**.

Conclusion

Let me conclude. The financial markets have been shaken to their foundations, which has revealed gaps in risk management, transparency, and scope and geographical reach of regulation and supervision. **Restoring confidence by maintaining the momentum in the implementation** of the ongoing global initiatives is crucial in the current situation. In this sense we need a sensible framework that ensures global monitoring of risk, mitigation of pro-cyclicality and the prevention of regulatory arbitrage between sectors and markets. Let me once again stress that the effective coordination of all policy initiatives is key for ensuring global consistency and success.

Europe can play an important role in defining the steps towards a new global financial architecture. Integrated European financial markets – and let me emphasise at this point that the process of integration must continue to be pushed forward – mean that coordinated European solutions must be found for the supervision of cross-border banks and the monitoring of systemic risks.

The next step is now the publication of a concrete proposal by the European Commission for discussion in the ECOFIN Council in June. I would therefore like to stress once more that the **ECB in collaboration with the national central banks, the supervisory authorities and the European Commission stands ready to assume the new tasks** in macro-prudential supervision that I have mentioned. We will need to identify and analyse systemic risks and make precise and concrete suggestions to the relevant authorities. This must be done at a European or global level!

Thank you for your attention.