Lucas Papademos: Financial stability and macro-prudential supervision: objectives, instruments and the role of the ECB

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at the CFS conference "The ECB and Its Watchers XI", Frankfurt, 4 September 2009.

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I. Introduction

Over the past two years, the financial crisis has clearly demonstrated the crucial role of central banks in safeguarding financial stability and the importance of the macro-prudential approach to regulation and supervision. As a result, in many countries or economic areas, the institutional framework for financial stability, which is being strengthened in the light of the lessons learnt from the crisis, incorporates new supervisory tasks and bodies responsible for the macro-prudential regulation of systemic risk. And central banks are envisaged to play a key role in the conduct of the macro-prudential supervision of the financial system as a whole.

In the EU, following the publication of the Report of the de Larosière Group[1], the European Commission proposed in May 2009 a set of ambitious reforms, including notably the creation of a new European Systemic Risk Board responsible for macro-prudential oversight. The European Council in June 2009 supported the Commission proposal.[2]

The establishment of a new framework for macro-prudential supervision in the EU has highlighted a number of fundamental issues concerning its objectives, powers and tools. And, in particular, it has raised some important questions on how the conduct of macro-prudential supervision relates to, and complements, the performance of other central banking tasks that can also contribute to financial stability.

In my remarks I will address three questions:

- What is the nature of the relationship between price stability and financial stability? In particular, is there a possible policy trade-off for central banks between the objectives of securing price stability and safeguarding financial stability?
- What are the objectives, tasks and policy instruments of the envisaged framework for macro-prudential supervision in the EU?
- What is the role of the ECB in contributing to financial stability and the macro-prudential supervision of the EU financial system?

II. Price stability and financial stability: is there a trade-off?

There is broad consensus that central banks' main responsibility is to preserve price stability and that they also have an important role to play in promoting financial stability. The ECB's objectives are clearly laid out in the Treaty. The primary objective is to maintain price stability. At the same time, Article 105 (5) of the Treaty stipulates that the ECB/ESCB "shall

[1] Report of the High-Level Group on Financial Supervision in the EU chaired by Jacques de Larosière, Brussels, 25 February 2009.

[2] Commission Communication, European Council Conclusions.

contribute to […] the stability of the financial system"[3]. The Eurosystem's Mission Statement states that "we aim to safeguard financial stability…".[4]

In many cases, the financial stability mandates of central banks, and the associated tasks to be performed, are specified in relatively general terms. There are several reasons for this. One reason is the complexity of the concept of financial stability and the challenges faced in specifying the associated policy objective in explicit terms. Another reason is that the powers and policy instruments necessary for the preservation of financial stability may be shared with other authorities.

At the ECB, we have defined financial stability as "a condition in which the financial system – comprising financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities".[5] It is clear from this definition that the objective of promoting and safeguarding financial stability cannot be defined in terms of a single indicator in a reasonably straightforward manner, as can be done with the price stability objective. Indeed, it has been argued that it may be preferable or more useful to define financial stability as absence of instability".[6]

Notwithstanding, the inherent difficulty in defining the financial stability objective with precision, a key issue for the central bank is the relationship between financial stability and price stability. Are these two conditions and the pertinent policy objectives complementary, or are there situations in which the simultaneous attainment of these two goals may pose a policy trade-off for the central bank? And, if the latter happens to be the case, does the central bank have sufficient powers and instruments to address this trade-off and achieve each objective without jeopardising the attainment of the other? Let me make a number of observations related to these questions.

In general, price stability and financial stability complement and mutually reinforce one another. And, consequently, the pursuit of the pertinent policy objectives does not involve any trade-offs. Price stability contributes to financial stability in a number of ways. For example, as most financial contracts are expressed in nominal terms, an environment of stable prices prevents an arbitrary redistribution of income and wealth between borrowers and lenders that could result from unanticipated price developments and lead to financial stress and potential defaults.

Moreover, monetary policy that credibly preserves price stability promotes financial stability. The benefits of the ECB's credible commitment to maintaining price stability have been demonstrated during the current financial crisis. Through the firm anchoring of inflation expectations to price stability, the ECB's monetary policy has minimised the risk of deflation. Moreover, stable inflation expectations have enhanced the effectiveness of monetary policy decisions in stabilising the economy, which is particularly relevant when nominal policy rates

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[3] Article 105(5) of the Treaty and Article 3.3 of the Statute of the Statute of the European System of Central Banks and of the European Central Bank state that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system".

[4] See http://www.ecb.europa.eu/ecb/orga/escb/html/mission_eurosys.en.html.

[5] See ECB Financial Stability Review, June 2009, p. 9. This definition implies that the safeguarding of financial stability requires the identification of the financial system's main sources of risk and vulnerability, such as inefficiencies in the allocation of financial resources and the mispricing or mismanagement of financial risks. Other definitions of financial stability that have been proposed also reflect the inherent complexity of the concept.

[6] A. Crockett (1997), The Theory and Practice of Financial Stability", GEI Newsletter Issue No. 6, 11-12 July. and R. Ferguson (2003), Should Financial Stability Be an Explicit Central Bank Objective? Fed Board, mentions that "It seems useful…to define financial stability…by defining its opposite: financial instability. "

are very low and face a lower bound. In turn, this has contributed to financial stability, both by helping to stabilise economic activity and by reducing the potential risk of a Fisherian-type debt deflation spiral.

Conversely, a stable financial system enhances the effectiveness of monetary policy in maintaining price stability in various ways, namely by facilitating the smooth transmission of monetary policy impulses, by containing the propagation and impact of macroeconomic economic shocks through the financial sector, and by reducing the incidence of shocks originating in the financial sector, from bank failures or the abrupt unwinding of sizeable imbalances in financial markets.

These observations imply that in general monetary policy actions can contribute to both preserving price stability and fostering or safeguarding financial stability. This can also hold true during periods of financial stress. For example, the non-standard measures implemented by the ECB over the past two years – in particular the introduction of full allotment at fixed rates in the provision of central bank liquidity in the Eurosystem monetary market operations – have contributed to financial stability by preventing a shortage of liquidity from becoming a widespread solvency problem with adverse effects on financial and price stability and the real economy. They have also contributed to price stability by supporting the provision of credit beyond what could be achieved through the favourable impact of interest rate reductions and by ensuring that the easing of financial conditions induced by policy rate cuts would be fully transmitted to firms and households at a time when financial markets and institutions were under stress.

That having been said, there can be situations when the constellation of the shocks affecting the real economy and financial markets, in particular, the impact of "structural" or "behavioural" changes related to productivity developments or market sentiment, may create trade-offs and pose challenges for central banks aiming at the simultaneous preservation of price stability and financial stability. Let me give you two examples. There can be situations in which financial imbalances emerge – with adverse consequences for future financial and price stability – in an environment of stable prices and the associated very low interest rates. And, indeed, it has been argued – and there is evidence to support this view – that an environment of very low inflation and a prolonged period of very low interest rates may be conducive to an underpricing of risk, an imprudent increase in leverage and the emergence of asset price bubbles. In such an environment, the central bank may face an inter-temporal trade off, if it aims at safeguarding financial and price stability over the longer term by tightening the monetary policy stance because of the potential impact of the tightening on shorter and medium term price developments.

Another example is provided by the situation in the euro area and elsewhere during the first year of the financial market turmoil, when inflationary pressures increased because of the effects of sizeable and persisting oil and other commodity price shocks, while the pace of economic activity was decelerating and the financial system was experiencing increasing stress. In such a situation, the ECB had to ensure the preservation of price stability, by preventing the emergence of second round effects in wage and price-setting, while at the same time addressing severe money market pressures and the impact of other factors threatening the stability of the financial system.

In such situations, involving possible policy trade-offs in achieving the objectives of preserving price stability and safeguarding financial stability, and when the determining factors and processes that threaten price and financial stability are not positively correlated, the central bank should be able to rely on an expanded set of policy instruments that can help achieve the two objectives simultaneously. During the first year of the financial market turmoil, the ECB addressed the unfavourable combination of, on the one hand, persisting and increasing inflation risks and, on the other, sustainable stress in the financial system and risks to its stability by using two instruments: the key monetary policy interest rate as well as liquidity provision and management. The level of the policy rate was defined so as to achieve

the primary objective of preserving price stability. At the same time, the Eurosystem engaged in active liquidity management in order to mitigate pressures in the money markets and their spill-over effects on financial markets and the real economy. This was done by adjusting the inter-temporal distribution of liquidity provision within the reserve maintenance period and the maturity profile of the refinancing operations, while maintaining the overall supply of central bank money broadly unchanged.

III. Macro-prudential supervision: its role, objectives and instruments

The need for an extended set of policy instruments for safeguarding financial stability is greater in order to prevent the emergence of financial imbalances and the recurrence of a financial crisis. The experience of the past few years and new evidence from research strongly suggest that monetary policy should aim at containing excessive risk-taking and unsustainable asset price developments that are often associated with persistent credit growth and rising leverage. In many circumstances, central banks can use policy interest rates to "lean against the wind" of financial market excesses, in a manner which is effective and consistent with the preservation of price stability over a longer term horizon. And the ECB's monetary policy strategy – with its medium term orientation and the emphasis that it places on the analysis of monetary and credit developments – is very well suited for this.

At the same time, past experience has also shown that there are limits to what can be achieved by relying solely on the interest rate instrument. The presence of short term policy trade offs in an environment of very low or even falling inflation, the relative "bluntness" of the monetary policy tool and the often difficult situation in terms of available information and analysis, put certain limits to the use of monetary policy for financial stability purposes. Moreover, market excesses and the pro-cyclicality of the financial system are also due to factors other than excessive credit growth and high leverage. Consequently, other policy tools must be employed – notably regulatory policy instruments – by the supervisory authorities in order to reduce procyclicality and also limit the emergence of systemic risks in the financial system. This assessment is also compatible with Tinbergen's rule that, in case of trade-offs between objectives, policy makers need as many (independent) policy instruments as objectives, in order to fully achieve them.

Furthermore, the extraordinary nature and consequences of the financial crisis – and here I am referring both to how close we came to a global financial meltdown and to the overall costs of the crisis for tax-payers in terms of losses in output and employment – have painfully demonstrated the need for improving and broadening the regulatory framework, by strengthening both the micro-prudential supervision of individual institutions and the macro-prudential supervision of the financial system as a whole.

The current crisis has revealed a general under-appreciation of systemic risks in the existing framework of financial regulation and supervision, which tends to focus on the stability of individual institutions, markets and infrastructures. The crisis also revealed that macro-financial factors, the inter-connectedness of markets and institutions and financial globalisation play an important role in determining the size, nature and propagation of systemic risk. Therefore, it essential – and there is a broad consensus on this – to establish an effective framework for macro-prudential supervision that will ensure a systematic, all-encompassing and integrated analysis of systemic risks as well as the formulation of appropriate policies to prevent address such risks.

The macro-prudential approach to supervision focuses on the financial system as a whole and involves the monitoring, assessment and mitigation of systemic risk, namely the likelihood of failure of a significant part of the financial system. It is important to recognise that systemic risk is partly endogenous as it depends on the collective behaviour of financial institutions and their inter-connectedness, as well as the interaction between financial markets and the macroeconomy. Macro-prudential policies aim to prevent, or at least

contain, the build up of financial imbalances and ensure that the financial system is able to withstand their unwinding and be resilient to shocks.

Central banks are well suited to be the authorities mainly responsible for macro-prudential supervision because of their expertise and analytical capabilities in the fields of monetary and financial stability analysis, as well as due to their closeness to the money and financial markets. The interlinkages between the financial system and the macroeconomy further strengthen the rationale for assigning to the central banks the responsibility for macro-prudential analysis and the formulation of recommendations concerning macro-prudential policies.

What is the nature of the policy instruments of macro-prudential supervision? Macro-prudential policies will concern, to a considerable extent, regulatory and supervisory action. They could take the form of general guidelines or concrete recommendations relating to the calibration of prudential tools. For example, macro-prudential recommendations could involve the adjustment of capital requirements or the setting of additional capital buffers in the banking system as a whole, or entail guidance regarding leverage ratios and liquidity management. Macro-prudential policies would not concern individual financial institutions.[7] While in principle a range of macro-prudential tools is available, the choice of the appropriate tools to address emerging systemic risks remains a challenge, requiring further analysis in order to identify the most efficient and effective instruments for the implementation of macro-prudential policies.

Obviously, the new macro-prudential approach to regulation and supervision has to be integrated with the existing micro-prudential structures. Macro- and micro-prudential supervision are complementary components and are part of the overall financial supervisory framework. The institutional arrangements for the performance of these two tasks must ensure effective cooperation and information sharing between the institutions involved in micro- and macro-prudential supervision.

Let me now focus on the envisaged macro-prudential framework in the EU and on the role of the ECB.

IV. The EU macro-prudential supervisory framework and the role of the ECB

Following the publication of the Report of the de Larosière Group in February 2009 and the Commission Communication in May, the Ecofin Council agreed in June 2009 that a new independent body responsible for the conduct of macro-prudential oversight in the EU should be established, namely the European Systemic Risk Board (ESRB). The creation of the ESRB was supported by the European Council on 18 and 19 June 2009. In the wake of these decisions, the Commission is preparing legal texts with concrete provisions concerning the establishment and functioning of the ESRB, which will be transmitted to the European Parliament and the Council in late September. These will be part of a broader package of legislative proposals including those for establishing the three new European micro-prudential supervisory authorities.

The European System of Central Banks (ESCB) will play a key role in the functioning of the ESRB. The General Board of the ESRB will comprise, as voting members, the Members of the General Council of the ECB (27 governors of the national central banks, the President and the Vice-President of the ECB), the Chairpersons of the three European Supervisory Authorities (ESAs) and a member of the European Commission. Representatives of the competent national supervisory authorities (one for each Member State) and the President of

[7] With respect to the adjustment of capital adequacy ratios, recent proposals point to adjusting the capital adequacy ratio of individual institutions according to their contribution to systemic risk or to the degree of compliance with corporate governance standards (see Brunnermeier et al. 11th Geneva Report, 2009).

the Economic and Financial Committee (EFC) will also attend the meetings of the ESRB. The participation of all the members of the General Council of the ECB in the ESRB will ensure that the financial stability analysis of the ESRB will benefit from the macro-economic, financial and monetary expertise of the EU central banks.

The main task of the ESRB will be to identify and assess risks to the stability of the EU financial system and issue risk warnings when the identified risks appear to be significant. When appropriate, the ESRB could complement its risk warnings with policy recommendations for remedial action.

The ESRB will not be responsible for the implementation of macro-prudential policies. The final responsibility for implementing the ESRB recommendations will remain with national supervisors and other national authorities. As the ESRB will not implement macro-prudential policies, the effective monitoring of the follow-up to its warnings and recommendations and their consistent and timely implementation will be crucial for the performance and the credibility of the new macro-prudential supervisory framework.

The ESRB will not perform its tasks in isolation; close cooperation with the other EU supervisory authorities will be vital for the success of the new supervisory framework. Indeed, according to the Commission Communication, the functioning of the new EU supervisory architecture requires efficient cooperation between the ESRB and the European System of Financial Supervision (ESFS), comprised of the three European Supervisory Authorities. This should ensure the appropriate interplay at the EU level between the macro- and micro-prudential levels.

The ESRB is also expected to liaise with global institutions. In line with the Commission Communication, the ESRB will need to set up arrangements for close collaboration with the IMF, the Financial Stability Board (FSB) and third country counterparts. This liaison with external counterparts is expected to help the ESRB identify and better assess risks stemming from outside the EU at an earlier stage than would otherwise be the case.

It is evident from the envisaged activities of the ESRB that its work will be wide-ranging and complex. It is the task of the ECB to assist this new body in performing its duties. According to the Council Conclusions, the ECB will provide analytical, statistical, administrative and logistical support to the ESRB. In particular, the ECB will assist the ESRB in the development and collection of new statistical data of relevance to the ESRB on a regular basis. The ECB will also assist the ESRB by developing and maintaining new analytical tools and methodologies for the identification and assessment of systemic risks and the issuance of early risk warnings, so that the ESRB effectively performs its tasks. This task poses important challenges because the identification and assessment of systemic risks require special skills and the further development of analytical tools. Models must be developed to help structure and analyse the vast amount of information collected for the risk assessment. Each model has its pros and cons, and serves different purposes. As financial stability and macro-prudential analyses are less developed than those in other policy areas, it is advisable to employ a multiplicity of approaches.

V. Concluding remarks

In conclusion, I would like to stress four points:

First, the ECB tasks related to its contribution to safeguarding financial stability are compatible with its monetary policy framework for achieving its primary objective of price stability. Indeed, the ECB's monetary policy strategy is very well suited for the potential use of the interest rate instrument in order to "lean against the wind" of financial market excesses, in a manner consistent with the preservation of price stability over the medium and longer term.

Second, the establishment of the ESRB and the attribution of macro-prudential tasks to the ECB will strengthen the ECB's capacity (its power and means) to contribute to financial stability, without interfering with the performance of its monetary policy tasks.

Third, the new body responsible for macro-prudential supervision in the EU should be independent in carrying out its tasks and pursuing its objective of assessing and regulating systemic risk. The fact that the ESRB will be responsible for the assessment of systemic risks and the formulation of pertinent policy recommendations, and that it will not be involved in the implementation of these recommendations strengthens the argument for its policy independence.

Fourth, the effective performance of macro-prudential supervision in the EU will require addressing a number of legal, institutional and governance issues. There are two key requirements for the successful functioning of the ESRB: The first is the establishment of a comprehensive and relevant information base as well as effective information-sharing and cooperation between the ESRB and the European Supervisory Authorities. The second is that suitable and sufficient mechanisms are in place in order to ensure the implementation of the macro-prudential recommendations.

Finally, I should emphasise that the ECB is actively preparing, in collaboration with the national central banks, in order to provide the appropriate analytical statistical and administrative support to the ESRB.