José Manuel González-Páramo: Reform of the architecture of the financial system

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Universidad del País Vasco, Campus de Leioa, Bilbao, 21 June 2010.

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Ladies and Gentlemen,

I. Introduction

It is a pleasure to be in the city of Bilbao, which hosts one of the finest modern art museums in Spain and Europe: the Guggenheim museum. With its very distinct architecture, this museum is the city's world-famous hallmark. Much as I love the design of the building, however, I will talk today about another type of architecture, namely that of the financial system. And just like the Guggenheim building, the current reforms of the financial system stir a lot of emotions.

We are dealing here with a very broad topic but I will approach it like a tourist visiting the Guggenheim museum. I will start by giving you a broad overview, describing the landscape as it were. I will briefly review the causes of the financial crisis and will run through the main initiatives that are on the plate of policy makers to prevent a crisis of such magnitude and severity ever recurring again.

Then I will turn to four eye-catching initiatives:

- *first*, the establishment of the European Systemic Risk Board or ESRB, a new body that will for the first time become responsible for macro-prudential supervision in the EU;
- *second*, how policy makers are dealing with systemically important institutions;
- *third*, the issue of procyclicality or the dynamic interplay between the financial sector and the real economy;
- *fourth* and last topic to which I will pay some more attention is the mandate of central banks in the area of financial stability.

Let us now embark on our architectural walk!

II. Causes of the current crisis

Much has been said about the root causes of the current crisis over the past three years. I will not expand on this topic but I will just mention specific factors – some of them of a macro- and others of a micro-economic nature – which in my view were key in the run up to the crisis.

In the two or three years before the crisis erupted, a constellation of factors, including very favourable macro-financial conditions combined with strong growth, low inflation, ample liquidity, exceptionally low volatility across virtually all financial markets and extraordinarily low risk premia, had the effect of covering up the building up of significant imbalances.

Significant financial imbalances were in the making, at various levels of the global economy and financial system. Among these were exuberant real estate prices, and a flourishing securitisation business, which facilitated excessive credit growth. A group of countries – including China, Japan, and oil-exporting economies – were saving too much, while others – such as the US – were heavily borrowing to finance consumption and investment. These developments were unsustainable in the long-run. At the same time, in an environment characterised by low interest rates, a global search for yield may have led investors to take on too much risk.

On the micro side, it became apparent that market participants' incentives were not aligned with the risks they were taking, and that some investors were not fully aware of the extent of their exposures, which contributed to the under-pricing of risk. In the banking sector in particular, deficiencies in the design of the prudential framework for banks, in the supervisory review of banks' risk management procedures and in the rules for compensation and pay were some of the microeconomic factors leading to important vulnerabilities.

III. Regulatory and supervisory initiatives currently under discussion

After witnessing the first *global* banking crisis since the Great Depression, it became clear that it was absolutely crucial to get the banking sector on a sound footing again. Policy makers responded rather quickly and forcefully to the crisis, which resulted in a wide-encompassing reform agenda.

This reform agenda is very ambitious and time-wise rather tight, but before describing the measures under discussion, let me first briefly introduce the main actors in this area. The G20 provides the political and strategic impetus for the reforms, with the Financial Stability Board (FSB) playing an important role in the policy coordination. Various committees and working groups, of which the most prominent is the Basel Committee on Banking Supervision, are charged with reviewing specific international standards.

As regards the reform agenda, the most important issues are the following:

- the adoption of high-quality capital and liquidity standards for banks,
- measures to reduce the financial system's procyclicality,
- the introduction of a regulatory framework for systemically important financial institutions,
- the regulation of credit rating agencies and hedge funds, improving OTC derivatives markets, and
- finally, sound compensation practices that support financial stability.

These issues are comprehensively addressed by *the Basel Committee's reform package* that aims to strengthening the banking sector's resilience and represents a cornerstone of the response to the crisis. The package, which was released at the end of last year for consultation, aims at improving the quality and consistency of bank capital. It also considers the introduction of a non-risk-based leverage ratio as a supplementary capital measure. This leverage ratio is expected to curb excessive balance sheet growth and to set a floor for the Basel II capital requirements. In order to mitigate the inherent pro-cyclical nature of financial activities, to which I will return later, the Basel *Committee's* proposals also contain capital buffers and forward-looking provisioning. Finally, the proposals include global minimum liquidity risk requirements enabling credit institutions to withstand a short-term liquidity stress and aiming to ensure longer-term stability in their funding requirements.

The objective of this comprehensive package is to enable financial institutions to better withstand the adverse effects of economic shocks. In order to assess the cumulative impact of the proposals, quantitative impact assessments are underway. The outcome will be available in the coming weeks, and will assist decision-makers in properly calibrating the measures. At this stage, therefore, it is premature for me to say anything about the desirable calibration of the measures. Nevertheless, I am of the view that the measures are warranted from a conceptual point of view, though their cumulative impact needs to be carefully assessed. Indeed, it is important that the right balance is struck between enhancing banking stability and maintaining a stable provision of credit to the economy.

IV. What has been done?

The main strands of the reform agenda I come to paint are at various stages of development. It is therefore useful to briefly run through what has already been achieved, in particular in Europe.

Starting with the *prudential framework for banks*, most FSB members, including the EU Member States, have fully implemented the more risk-sensitive Basel II framework.

Amendments to the *trading book* are due to be implemented no later than the end of 2011 to address the problem of excessively low capital charges for trading activities in the pre-crisis period. In the EU, the appropriate measures are included in amendments to the Capital Requirements Directive, the so-called CRD3 package.

The FSB just finished its peer review on how its members implemented the agreed principles for *sound compensation practices*. In the EU, the CRD3 has specifically included banks' remuneration policies in the supervisory review.

An EU regulation on credit rating agencies – which will come into effect at the end of 2010 – was adopted last year. The European Commission has recently proposed amendments to the regulation which aim to introduce a centralised framework for supervision of the agencies at the EU level. Under the new supervisory framework, an European Securities and Markets Authority with oversight and supervisory powers over credit rating agencies will be established. Efforts in this field aim to address some shortcomings of the credit rating sector revealed by the crisis, such as conflicts of interest, poor rating quality and insufficient transparency about the methods used for their evaluations and the procedures for rating decisions.

A legislative proposal that establishes regulatory and supervisory standards for *hedge funds* is also under consideration in the EU.

Finally the two major accounting standard setters, IASB and FASB, are continuing their efforts to achieve convergence of accounting standards, though it might not be possible to keep to the initially agreed time table.

I turn now to a very important response in Europe to the crisis, which is of particular interest for the ECB: the establishment of the ***European Systemic Risk Board*** or ESRB. This new body will be responsible for macro-prudential supervision in the whole EU. In contrast to micro-prudential supervision, which focuses on the financial soundness of individual institutions, macro-prudential supervision looks at the financial system as a whole.

Up to the late 1990s, the predominant view of policy makers was that if individual institutions were financially sound, the financial system as a whole would also be fine. Unfortunately, this is not always the case. Through various channels, institutions can be inter-linked so that problems emerging from one or some of them may spill over to the rest of the financial sector, setting in motion an adverse dynamic that affects all of them. A macro-prudential perspective, looking beyond the conditions of each institution in isolation, should help to detect and prevent such system-wide potential problems.

Of course, there were already in place mechanisms for the monitoring and assessment of financial stability well before the financial crisis erupted, as evidenced by the financial stability reports published by the various central banks. But the financial crisis also demonstrated fundamental weaknesses in practices:

- *First*, while various central banks engaged in their own financial stability analysis there was not really a comprehensive analysis covering the whole EU and all elements of the financial system.
- *Second*, many of the analyses expressed serious concerns, such as the persistence of global imbalances and the investors' hunt for higher yields, but these concerns were not sufficiently followed-up by concrete action.

There is therefore a need to improve the interplay between micro- and macro-prudential supervision since many tools to correct for possible risks are in the micro-prudential realm. To this aim, the ESRB will be able to issue risk warnings and, where appropriate, recommendations and follow-up on their implementation.

The legislative proposals for the establishment of the ESRB that are currently being discussed among the relevant European institutions foresee an important role for the ECB in the ESRB and we stand ready to take up this role. We will do this with the support of the other members of the European System of Central Banks (ESCB), the constellation of the national central banks of the European Union. The ECB will support the ESRB by providing analytical, logistical and administrative support to the ESRB as well as the ESRB Secretariat. Preparatory work at the ECB is underway so that the ESRB can take up its work right after its formal establishment, which is expected for early next year.

The ECB is also in the process of enhancing its own capabilities for monitoring and assessing financial stability risks, not least to provide high-quality analytical input to the ESRB. In the pursuit of this objective, we also try to draw as much as possible from synergies with existing work and resources both within the ECB and the ESCB, as well as at the supervisory authorities.

I conclude on this point that the establishment of ESRB will be a watershed event in developing a macro-prudential framework for Europe. Having said that, I should also say that the ESRB does not have an easy mission and it certainly faces many challenges. Macro-prudential supervision is relatively new, which implies that a well-established framework with a clear operational objective, as we know for monetary policy, must yet be set in place. The ESRB will therefore have to develop its own thinking and strategy, and will probably have to advance in a pragmatic way.

The interplay with the micro-prudential function will be crucial, not only because the ESRB will have to rely to a large extent on micro-prudential supervisors for the information and the data, but also because a number of the tools that can be expected to address potential weaknesses in the financial system are of a micro-prudential nature. In that respect, I should recall that the ESRB will not have any binding powers but will have to rely on moral suasion and peer pressure for the follow-up to its risk warnings and recommendations. And finally the ESRB will have to strive for effectiveness and efficiency in the pursuit of its tasks, given its relatively wide composition (over 60 members).

V. A look into the future

Taking a forward-looking perspective, I am sure that one of the important topics that will be on the ESRB's agenda is that of the ***systemically important financial institutions (SIFIs)***. These institutions are major contributors to what in the financial jargon is known as "systemic risk" and are, therefore, of great interest to macro-prudential supervisors. How to gauge the contribution of a financial institution to systemic risk, in other words how to identify a SIFI, is a very difficult task, not least because of data limitations. Nevertheless, there are a number of factors that seem to be particularly relevant, such as the size of the institution, its interconnectedness with the rest of the financial system and the degree of substitutability in the event of a failure of the critical services they provide. It is clear that any such assessment cannot be exclusively based on a quantitative approach. Rather, the informed judgment of the relevant authorities, guided by internationally agreed principles, will play an important role.

Indeed, the concept of systemic risk is fuzzy and still under debate, but, with a certain degree of simplification, it can be defined as the risk of an impairment in the financial system that has potentially serious negative consequences for the real economy. For example, the actual default of a major bank may seriously affect depositors' savings (though reimbursement up to the insured level of retail deposits is to be provided by deposit insurance schemes) and the financing of otherwise profitable investment projects.

But even in case of no actual default, SIFIs may pose serious challenges. Because of the potentially high damage to the financial system and the real economy in case of default, there is the expectation that governments and supervisors would not let a SIFI fail. This implicit support may provide an incentive to the institution to engage in profitable but risky activities, giving rise to "moral hazard". It also means that a SIFI can finance itself at a lower cost compared to other similar institutions, which are not deemed to be systemically important. In short, incentives are misaligned and the playing field is distorted. These problems have probably increased in the wake of the financial crisis following some of the voluntary, and less-voluntary, marriages among institutions that have created even bigger and more complex financial groups.

Reflecting these concerns, at the G20 summit of April last year in London, it was decided that SIFIs should be subject to an appropriate degree of regulation and oversight. At the same time, the G20 entrusted the FSB with the task of overseeing concrete regulatory steps and monitoring their implementation. The FSB is now considering various policy options to address the concerns I mentioned.

In general terms, there are two ways to address ex ante the problems that SIFIs pose: you can restrict the scope of their activities or force them to internalise the costs they pose to the system. The clearest illustration of the first approach is the discussion on the "Volcker rule" in the United States. Under this rule, banks that receive deposits would be prevented from engaging in proprietary trading, and investing in or sponsoring hedge funds and private equity funds. I do not believe this is the most fruitful way to pursue in Europe, given the traditional strength of the universal banking model in a number of Member States. Also, there may be challenges associated with defining the borderline between the proprietary trading and servicing clients. But more importantly, the activities that are seen as deserving special attention may move outside the intensively regulated and supervised banking business, but stay within the same group.

One could argue that the same effect of controlling for risks stemming from the trading business can be reached by imposing higher capital requirements on banks' trading book activities, and this seems to be the way that is being pursued internationally. The Basel Committee has already increased the capital requirements for a number of trading book activities, and a fundamental review of the trading book is planned for next year.

The Basel Committee is looking as well into how to get the SIFIs to internalise the potential costs they pose to the financial system. This can include a variety of measures, such as higher capital and liquidity requirements, more intense supervision, concentration limits, etc. Work is still under way on defining such possible measures. The FSB is expected to provide recommendations to the G20 summit of November in Seoul.

An alternative way to make banks internalise the externalities they pose on the financial system is through a bank levy. A levy responds more directly to the need to raise a contribution from the financial sector in order to pay for the cost of past or future financial crises, depending on whether the levy is imposed ex-post or ex-ante. For instance, the proceeds raised by a levy can be destined to finance a dedicated fund to be activated in the future for the orderly winding down of distressed banks. The EU Commission is moving forward in this area, with the aim of establishing a common framework for a levy in the EU member states. The IMF is also finalising a report on this topic for the G20 summit later this month in Toronto. In my view the discussion should be properly framed in the overall reform of the prudential framework, including the quantitative impact assessment of the various initiatives I mentioned earlier. Such a careful assessment is warranted, inter alia, to avoid imposing an undue burden on the banking sector and, ultimately, hamper the flow of credit to the real economy.

Another important element of the Basel reform package is the introduction of a range of measures designed to mitigate the inherent ***pro-cyclicality*** of the financial system. In this context, mechanisms that enhance prudent and forward-looking provisioning of banks as well as the building up of sufficient capital buffers in years of economic expansion that can be drawn down at times of stress, are all under consideration. Overall, these measures aim at ensuring that the financial system functions as an absorber, rather than an amplifier of shocks, thus smoothing the volatility of the financial and real economic cycles.

In setting up a more forward-looking provisioning framework, the Basel Committee works closely together with the accounting standard setters with a view to developing a sound operational framework for expected loss provisioning. In this context, let me mention as very important the collaborative efforts under way between the Basel Committee and the IASB to develop a revised expected loss model that proves operational.

Concerning measures on capital buffers, the Basel Committee set forth a proposal on a capital conservation buffer that would establish certain restrictions for undercapitalised banks with regard to the distribution of earnings in the form of dividends, share buy backs and bonuses. In addition, the introduction of a counter-cyclical buffering mechanism is also considered. It would require banks to build up additional capital buffers when excessive credit growth is identified in the economy.

The last topic I want to pay some attention to is ***the role of central banks in financial stability***. The experience of the financial crisis was not only an important trigger to set in motion supervisory and regulatory reform. It also drew attention to the need to develop comprehensive financial stability frameworks in which identification and assessment of system-wide risk are translated into macro-prudential policy action. Considerable efforts are being put in place at the European and global level in discussing such a framework and how to make it operational.

Central banks, on account of their experience in financial stability should be important players in the macro-prudential analytical and policy fields, as reflected in the composition of the ESRB. This should not interfere with the primary responsibility of central banks, which should inflexibly remain the maintenance of price stability. To the contrary, the successful pursuit of the primary objectives of monetary policy and macro-prudential policy should reinforce each other.

In particular, measures that enhance the resilience of the financial system or that address rising financial imbalances are likely to contribute to increase the effectiveness of monetary policy by reducing the impact of financial frictions on the supply of credit. Conversely, as demonstrated in the run up to the crisis, price stability is not sufficient to safeguard financial stability, but it is certainly a necessary condition for it. Indeed, it reduces the system's vulnerability to the build-up of financial imbalances and the scope for risk mispricing.

The financial crisis has well illustrated how the monetary policy transmission channel can be seriously hampered in the absence of financial stability. This points to the many benefits from leaning against the build-up of financial imbalances, while pursuing the price stability objective. To some extent, successful macro-prudential policy could alleviate the need for monetary policy to "lean against the wind" as regards unsustainable financial trends. The two policy areas should however operate with a clearly distinct set of tools. Effective governance arrangements need to be in place, so as to maximise credibility and preserve institutional independence.

IV. Conclusions

Ladies and gentlemen, I started my talk with a reference to architecture and, as we progressed, I reviewed the many building sites – at various stages of development – of the reforming financial system. It will be very challenging to keep momentum in the reform agenda and to keep the activities of the many building sites on track as "battle fatigue" inevitably settles in. But the crisis has also painfully demonstrated that sound foundations are indispensable to withstand the occasional blows that hit the financial system. Therefore, it is all the more important to continue vigorously pursuing the ambitious financial reform agenda. I thank you for your attention.