Yves Mersch: European lessons to be drawn from the crisis to improve global financial stability

Speech by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the 54th Congress of the International Association of Lawyers (Union Internationale des Avocat, UIA), Istanbul, 31 October 2010.

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Excellences, Ladies and Gentlemen,

Three years after the first turbulences occurred on the interbank markets, it is apparent that they marked the beginning of the most severe crisis since the end of World War II. As the crisis is not yet over, we still lack the perspective of setting up a comprehensive list of lessons from the crisis. Nonetheless, I thank the International Association of Lawyers for inviting me to share my views on this issue.

In my speech, I will highlight the causes of the financial crisis, the political responses, and the likely consequences. In particular I will make clear, that policy responses cannot be applied globally but need to take into account the structure and special features of an economic area.

As a member of the Governing Council of the European Central Bank (ECB) I will elaborate on the European experiences and challenges and the role of monetary policy in particular. However, what I will say should not be interpreted in the context of the future monetary policy decision of the Governing Council next Thursday. You might recall that my colleagues and I are in our purdah period.

Causes of the crisis

Let me start with an overview of the causes of the financial crisis, giving examples of market and government failures, referring to an excellent analysis by Guillermo de la Dehesa, Chairman of the Centre for Economic Policy Research (bold mine):

“The first failure appeared when the U.S. government tried to encourage wider ***homeownership*** by households, allowing every American family to be entitled to mortgage loans, regardless of their income level or their ability to pay, thus creating a problem of “adverse selection”. […]

The second failure occurred in the originated and securitized ***subprime*** **mortgages** market, both in terms of government regulation and supervision. On the one hand, the majority of mortgages were not originated by the banks but by agents and brokers working on commission, who were not regulated and who were only required to obtain an administrative local state permit to sell financial products. Therefore, their main objective was to sell a mortgage to a family and charge a commission without much effort to verify whether the mortgage holder could pay it. […]

The third major failure was that many banks that were ***securitizing*** mortgages and selling them believed that they had removed their risk burden – an idea that ultimately proved not always to be right. […] In other words, the banks were creating a parallel, off-balance-sheet banking system that would take short-term resources and invest them in long-term risky assets that were neither regulated nor subject to supervision.

The managers of many of these special vehicles were buying the same structured products based on subprime mortgages. Through this vehicles, they were taking on the same risk that bank had intended to transfer by securitizing and selling them to a third party.

If the Federal Reserve and the European Central Bank had forced the banks to reintroduce the securities into their balance sheets (which they never should have removed in the first place), the banks would have consumed regulatory capital that they did not have. This would have resulted in an even greater credit crunch that what ultimately occurred.

What is most significant is that, were it not for these vehicles and the parallel banking system created, there would be no other reasons to explain why a problem that originated in the U.S. mortgage securitization system was able to spread in such a way to the European banks.

The fourth incomprehensible failure needs to be attributed to the way ***investors*** themselves have behaved. These investors were managing very large bank, pension, and insurance asset portfolios or hedge funds and were supposed to have accumulated a high degree of expertise in investing (as high as the fees they charged). […] How was it possible that so many of theses sophisticated investors were buying these structured products with a AAA or AA rating without being able to understand their content due to the huge mathematical complexity of their structures? The only explanation is that they bought these products because they were more profitable than the traditional AAA- or AA-rated assets, which is in itself an oxymoron in terms of finance theory.

The fifth failure both in market and governments was associated with ***the credit rating agencies*** that assess the default risks associated with financial assets that are issued, bought and sold in the markets. […] These credit agencies are also privileged in that they cannot be legally prosecuted. That is, they have no legal or administrative responsibility (like auditors have) over the ratings they give because of the protections they enjoy under the first amendment of the U.S. Constitution; their employees are considered to be merely "financial reporters" that are exercising their "freedom of expression".

After 1970, the agencies were funded by the issuers and sellers of bonds or structured products who they are supposed to monitor and rate, thus creating a large conflict of interest: On the one hand, the bond issuers can decide not to contract an agency if they get a provisional rating that they consider to be low, and can attempt to contract with another that will give a higher rating, since they know what rating they will receive before they make a decision.

The sixth major failure during the 2008–09 financial crisis was committed by the ***banks*** themselves and other financial entities when they failed to effectively carry out their main responsibility of serving as an intermediary between the savings of depositors and the investments of investors in an economic system. […]The reason the financial system exists is based exclusively on its capacity to compile and analyze information.

For both depositors and investors, this kind of activity demands a very high level of trust in the accuracy and quality of the information and advice provided by the financial intermediaries. If this level of trust is broken, as was the case during the 2008–09 financial crisis, it can ultimately paralyze the activities of the financial intermediaries and the markets, generate uncertainty, and eventually cause panic, producing a run on the banks and paralyzing markets, leading to serious negative consequences for the overall economy.

Four characteristics make banks key players in a market economy:

First: billions of payments requiring transfers of funds are carried out by the banks every day. They run the payment systems that underpin economies transactions.

The second characteristic is that banks and other financial intermediaries borrow short from depositors or other savers and lend long to investors, subsequently incurring interest rate, term mismatching, and counterparty risks that make them highly vulnerable to any abrupt change in economic conditions. Therefore, they are a public service that takes important risks.

The third is that these entities undertake very important and necessary tasks for the success of the economy by channelling resources from the savers to the investors and by transferring the risk from those who cannot afford to take them to those who are willing to assume them.

The fourth is that banks are needed to ensure effective implementation of monetary policy. Monetary policy is the most relevant economic policy for softening the impact of economic fluctuations and cycles and for maintaining price stability.

The seventh serious failure was in economic banking: A new economic theory surged based on two hypotheses: “rational expectations” and “efficient and complete markets”. Theses new theoretical developments were the intellectual basis of the rise of a new political trend toward financial deregulation.

Also in some area monetary policies were aimed at maintaining low interest rates, resulting in two huge bubbles in a single decade, the 2000 dot-com and 2007 financial and real estate bubbles.

The eighth failure relates to ***banking supervision***. On most cases, the largest bank failures and the most expensive bail outs have coincided with countries where the supervisor was not the central bank, but the governments. […]

The ninth significant problem, associated with market failure is that many banks failed to ***manage*** their ***risk*** appropriately and sufficiently. Sometimes, as mentioned, it is because of pressures from the shareholders to get a higher return on equity; and sometimes it is because of the executive remuneration system which encourages greater risk taking. Other times it is because the executives believed that their long term financing would remain cheap since basic interest rates would continue to be low. […] Good risk management begins with the basic rules of common sense and caution, not with complex models taken from physics.

The tenth market and regulatory related failure has been the enormous development of bilateral or ***over-the-counter derivatives markets***, for both foreign exchange and loan interest rates, that have reached never-before-seen historic levels. […]

The eleventh failure was the shortcomings of the ***Basel II Accord*** allowing increased leverage in larger banks.

The twelfth and final failure detected in the 2008–09 financial crisis is the moral hazard created by the prominence of banking systems that are “too big and too interconnected too fail” or “too big to be saved” because they can create ***a systemic crisis*** in national and global banking networks with very serious economic consequences for the entire world economy. The large banks and their networks that know they will be bailed out by governments if ever faced with solvency issues have an incentive to take on greater risk than a bank or intermediary that fails with no entity to save it.”[1]

In a nut shell: these shortcomings jointly allowed the entire financial industry to book profits too early, too easily and without proper risk adjustment. At the same time they covered a process of excessive indebtedness in the private and financial sector.

The tensions increased and erupted in the financial crisis that started in the summer of 2007, deteriorating severely in September 2008 when the former US investment bank Lehman Brothers collapsed pushing the global economy to the edge of the abyss.

Political responses

The financial crisis and the subsequent economic downturn have called for unprecedented policy responses by both fiscal and monetary authorities worldwide.

[1] See de la Dehesa, Guillermo (2010): Twelve Market and Government Failures Leading to 2008–09 Financial Crisis, Occasional Paper No 80, Group of Thirty, Washington DC.

Differences in the economic and financial structures and the political set up of the Euro area compared to the United States led to different specific measures – aiming at achieving the same goals, however. Let me elaborate on these structural differences:

– First, the economic structures of the Euro area and the United States differ a lot. Small and medium-sized enterprises, for example, play a dominant role in the European economy. Moreover, the public sector represents bigger parts of the European economy, and is a major player in the ownership structure of certain banks. Overall, the economy in the Euro zone is less flexible than in the US. Wages and prices are slower to adjust. Let me provide an example from my "home turf". Prices change rather infrequently in the Euro area. On average it takes retailers 13 months to reprice their products. According to surveys, it is 11 months for producers. In the United States, comparable figures indicate durations of less than 7 months and slightly more than 8 months respectively.

  Whereas this lower flexibility might be a disadvantage to benefit from positive supply side shocks like technical innovations, during the time of a crisis this European "sluggishness" offered some protection against an overshooting of negative expectations leading to a deflationary spiral.

– Second, there are also profound differences in their financial structures. The differences in the composition of funding sources for non-financial corporations are striking. Europe's small and medium-sized firms have no direct access to capital markets but need loans to finance their activities. In the Euro area bank financing accounts for roughly 70 % of firm's total external financing. In the United States, by contrast, firms rely to a much larger extent on market-based sources, which represent 80 % of total external financing. Also, universal banking is the predominant business model in continental European banking compared to the US which – before the outbreak of the crisis – were characterized by specialised investment banks.

In its fight against the crisis the ECB always has taken account of this particular structure of the euro area economy. To be effective, the applied measures of the ECB concentrated on the banking sector and the provision of liquidity. In the US, by contrast, the Fed focused on capital markets and bought assets outright on debt capital markets – an appropriate strategy given the reliance on capital markets of US companies rather than on bank loans.

The ECB's focus on the banking sector applied to all three stages of the crisis from the European perspective

– Abundant liquidity provision when tensions in the money market first occurred in August 2007.

– Unprecedented rate cuts from October 2008 on, when the economy slipped into a deep recession. To support the supply of credit to the real economy the ECB additionally employed some unconventional measures to alleviate the funding pressures in the banking sector.

– Intervening in certain market segments to ensure the functioning of the transmission mechanism of monetary policy when sovereign debts markets came under severe pressure in Mai 2010.

These bold and innovative measures helped to sustain financial intermediation in the euro area. Moreover, it maintained the availability of credit for households and companies. At the same time they have been compatible with the ECB's primary mandate of maintaining price stability over the medium term.

Longer term objectives

Sound financial sector

Beyond the crisis, the financial sector must become more resilient, the massive debt burden has to be eroded and new excesses in indebtedness must be prevented the financial, the private and public sector. The de-risking of the financial industry and the deleveraging of excessively indebted private households and countries are the long term objectives for a sustainable financial and economic system.

Regulation and supervision of the financial sector have to reduce the probability of institution failure. Higher quantity and quality of capital, minimum liquidity requirements and leverage limits, as demanded by the Basel Committee on Banking Supervision, aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, independent of the source.

However, the current proposals for new capital and liquidity rules ignore the importance of bank credit as the dominant means of finance in the Euro area, the basically well functioning system of universal banks on this side of the Atlantic.

Although it is important to call for sound liquidity risk management and robust capital buffers, it seems awkward to target deposits and loans of banks as major threats to financial stability given the experience of the crisis. The universal banks in continental Europe, which rely on deposits as a major source of finance, were more diversified with retail and corporate lending operations and fund management than their US counterparts. Their solid deposit base provided stability to the system as a whole.

By contrast, the "originate-to-distribute model" pushed forward risky and opaque products, which were at the epicentre of the subprime crisis. Only those European banks got into trouble that embarked into investment banking activities or had bought toxic assets on a large scale. But the crisis also revealed weaknesses of business models based on public sector support or public financing.

The additional ratio for systemically important financial institutions (SIFIs) can be questioned in so far as it sanctions the traditionally larger banks of continental Europe. Such large banks are unpopular in the US – without being necessarily more risky.

The negative consequences of Basel III, that sanctions bank loans as relatively risky and illiquid, imposing higher capital requirements and haircuts, are threefold:

– The formerly stable universal banks of continental Europe would be pushed into riskier activities when the margins of lending to smaller and medium sized firms were diminishing due to regulatory requirements.

– The new rules lead to comparative disadvantages to the European banking system. The US banks rely more on fees than on deposits. The global playing field will be tilt.

– As the real economy is mainly financed by the banking system, financing conditions for companies without access to the capital markets would tighten and trigger a negative impact on economic growth.

As the former IMF head and Governor of the French Central Bank, Jacques de Larosière, put it recently: "The cruel irony is that the banking system model that most favours financial stability and economic growth could be the chief victim of the new framework."

A remaining challenge is to regulate and supervise the shadow banking system. Moreover, it has to be made sure, that Basel III will be implemented at the time in all jurisdictions to guarantee a level playing field. As we know, this was not the case for the Basel II rules.

Institutional reform

Also, on the institutional level reform is necessary. Here again, a one-fits-all-answer will not be appropriate. The US did consolidate its highly fragmented regulation regime. Banking there is regulated at both the federal and state level. Depending on a banking organization's charter-type and organizational structure, it may be subject to numerous federal and state banking regulators.

Europe also has to overcome national fragmentation in this respect. Despite some initial temptations for re-segmentation of prudential competences, the response will be at the European and at the EU27 level. It will consist of the implementation of new concepts and institutions aiming at de-risking the financial industry. Liquidity monitoring through a monthly liquidity coverage ratio and a yearly net stable funding ratio will be complemented by macro prudential surveillance in a European System Risk Board closely associated with the General Council of the European Central Bank. The US equivalent to this Systemic risk Board recently held its inaugural meeting.

Three European Agencies for banking, securities markets and insurance start with a mostly coordination function, but have certain evolutionist competence clauses in their statutes. They have to walk the narrow line between cross border activities of banks and integration of markets on the one hand and competences remaining at national levels like deposit guarantee schemes, resolution procedures, and insolvency legislation, i.e. everything that pertains to the tax payer who remains fiercely protected by national governments despite the spill-over effects of cross border activities, on the other hand.

To tackle these effects through a potential 351 bilateral Treaties in so many areas among 27 member states, can hardly be seen as a stable equilibrium in decision making nor a level playing field for economic activities in a single area.

The new institutional set-ups at EU level therefore face some of the same problems we experience within the Euro-area. The ultimate goal will however be the same: foster economic welfare through integration of markets and market players.

Fiscal challenges

Learning from recent experience, we have to examine carefully the role of excessive debt. After collapse of Lehman brothers in September 2008 the accumulation of private debt was suddenly stopped, but the problem of excessive indebtedness was not solved. Fiscal rescue packages, the impact of automatic stabilizers, and the necessary support of the financial system led to a significant increase in public leverage to levels unprecedented in peacetime.

Government debt in the euro area will have grown by more than 20 percentage points from 2007 to 2011. The equivalent figures for the US and Japan are between 35 and 45 percentage points. Debt-to-GDP-ratios are approaching 90% in Europe, 100% in the US and the UK, and 200% in Japan.

The debt burden must be eroded and new excesses in indebtedness have to be prevented. This holds particular for the Euro zone because a single monetary policy needs to be supported by sound public finances.

Fiscal and macroeconomic surveillance need to be empowered. The recent discussions within the European Council show a lack of ambition compared to the already timid proposals of the Commission; although the designed new fiscal framework might speed up a faster and broader-based imposition of sanctions on countries that do not comply with the SGP rules.

It is to be hoped that the European Parliament will revert to an automatic sanction mechanism. Indeed, it should be possible to start with some sanctions even before a country breaches the 3%-of-GDP rule, thus strengthening the preemptive side of the framework.

Concluding remarks

Having stabilized the global economy over the last three years, the current challenge is to return on a path of increased stability. This will have distinct consequences for the global economy.

Given the massive debt burden that has to be eroded, the industrialized world will experience lower growth potentials. On top, the necessary reduction of debt will lead to slower growth rates in the short term as the unavoidable consequence of the deleveraging process. Sustainable, longer-term growth, however, can only be reached when fundamental economic imbalances are tackled and structural reforms are initiated. In Europe, more ambitions and commitment by political leaders are needed.

Stricter rules and higher capital requirements for the financial industry will make the system stronger and healthier. But effective regulation also requires on-the-ground supervision based on competence and proximity. Rules appropriate for the marked based model should not be applied to the heterogeneity of the European system. As the economy in the Euro area is largely based on the availability of bank loans any regulatory change must take account of that. Otherwise, continental banks might suffer from competitive disadvantages. As a consequence financing conditions for the real economy might deteriorate, dampening growth and job creation.