Vítor Constâncio: Regulation and supervision of financial services in Europe – reforms and results

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 13th Euro Finance Week, Frankfurt am Main, 16 November 2010.

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I am pleased to take part in this conference, today, dedicated to risk management and to open this first session on regulatory and supervisory reform in Europe.

The concept of systemic risk underlies the changes in the regulatory framework and supervisory architecture in the EU and, to a large extent, around the globe. The financial crisis has shown how the materialisation of systemic risks can have devastating effects for the financial sector and the broader economy. This has underscored the need to strengthen macro-prudential oversight of financial systems and to strengthen micro-prudential supervision of individual institutions. The need for enhancements in risk management systems of financial market participants at large has also been highlighted. Therefore, the need for a better understanding of the concept and measurement of systemic risk, on both the private and regulatory sector sides, and how to limit it or mitigate its damaging effects, is at the core of the new regulatory and supervisory framework we will discuss today.

In my remarks, I will touch upon these issues, with a focus on macro-prudential oversight and policy and on the soon-to-be-established European Systemic Risk Board, which will be responsible for this function at the EU level. I will start by reflecting on the new macro-prudential oversight framework for the EU. I will move on to the ECB's role in macro-prudential analysis at the EU-wide level, with a view to providing analytical support in the ESRB's decision-making process. I will then discuss the information basis for risk identification and risk assessment, and focus on the interaction with the European Supervisory Authorities, or ESAs, and with the financial industry in this process. Finally, I will recall the regulatory and micro-prudential dimension, as well as the contribution of the financial industry in the move towards a more stable financial system.

1. The new EU framework for macro-prudential oversight

The financial crisis has revealed a substantial policy gap between financial stability oversight and targeted policy responses to mitigate risks considered to be potentially systemic. This deficit calls for the strengthening of the macro-prudential approach to regulation and supervision at the national and international level.

The role of central banks in this process has emerged as critical, mostly on account of their responsibility in safeguarding financial stability, their analytical capability in the analysis of risk from a system-wide perspective and their proximity to financial markets and market participants. Testimony to this is the institutional response around the globe. In the United Kingdom, the Bank of England has seen its responsibilities in both the macro and micro-prudential fields enhanced. In the United States, the Federal Reserve System became the principal macro-prudential supervisor with competencies in prudential policy design and implementation, emerging with a more prominent role. The European Systemic Risk Board, chaired by the President of the European Central Bank, will become operational in January 2011 and will be responsible for macro-prudential oversight in the EU. The ECB will provide analytical support to inform ESRB deliberations and also its Secretariat.

More broadly, in a number of EU countries and elsewhere around the world, even if changes to the institutional set-up have not been launched, a redefinition of macro-prudential strategies is underway. A common element of these strategies is the closer cooperation between micro and macro-prudential supervision – irrespective of whether this is conducted by the same or different authorities – with a view to better assess interdependencies across individual institutions and between the financial sectors and the real economy.

This feature is also critical for the EU-wide macro-prudential framework, where close interaction between the ESRB and the three new ESAs for the securities markets, banking and insurance sectors is of the utmost importance. This interaction has to be continuous, starting with the formation of a comprehensive and detailed information base for the screening of risks and comprising the discussion of risk assessments from macro and micro-prudential perspectives and the design of policy responses, should the identified risks be considered of a systemic nature.

2. The ECB's analytical support to the ESRB

Let me now turn to the ongoing preparatory work at the ECB on the analytical front to inform discussions within the ESRB and to support its deliberations.

The focus of the analysis is clearly on the systemic dimension of risk factors and their interconnectedness. Treating aggregated risk as endogenous clearly differs from the risk analysis approach carried out from a micro-prudential perspective or by financial institutions individually, where aggregate risk, stemming from other financial institutions' actions and the overall environment, is perceived as exogenous.

To support the risk identification process at an EU-wide level, the risk surveillance that we plan to undertake – in the same fashion as done, for instance, at the ECB in the context of the preparation of our Financial Stability Review – needs to have a wide reach, monitoring markets, financial institutions and the economy at large, so as to ensure that no risk is overlooked. Several analytical tools and models are being developed for this type of analysis, including early warning models and financial stability indicators that use the information content of available financial and macroeconomic data to identify, early on, where imbalances may be building up. Important variables to monitor in this context are, for example, measures of bank leverage, balance-sheet growth, maturity mismatches, property price changes, private sector leverage and current account deficits. Contemporaneous financial stability indicators, capturing the state of system stability and forward-looking indicators revealing the market perception of the probability of an adverse systemic event in the period ahead (e.g. calculated on the basis of credit-default swap spreads) are also important risk surveillance tools.

The risk identification process would support the design of risk scenarios and the discussion of possible triggers that could lead to their crystallisation, supported by current and projected macroeconomic and financial variables.

Once a set of risks has been identified as potentially systemic, the second leg in the analysis is the assessment of the severity of those risks, as well as an evaluation of the ability of the financial system to absorb their impact. This step will form the basis for risk prioritisation and inform the ESRB in its decision on a possible need to issue a risk warning. It is therefore most closely associated with the policy action, and for this reason, a well-developed analytical framework is needed that allows us to quantify both the likelihood and the severity of a specific risk in order to support the ESRB's decisions. Clearly, there is widespread awareness that the analytical framework, no matter its level of sophistication, cannot replace the expert knowledge and judgment of the ESRB's members. However, a consistent analytical framework and rigour in the analysis would provide valuable input to the Board's discussions and back deliberations on risk warnings and policy recommendations.

Analytical tools to assess the severity of identified risks and overall resilience of the financial system clearly include macro stress-testing models.

An EU-wide stress-testing exercise, prepared and conducted by the CEBS and national supervisory authorities, in close cooperation with the ECB, was completed in July this year.

The exercise included adverse scenarios that reflected severe assumptions, especially in relation to sovereign risk and growth paths. Such adverse scenarios, although not very likely to materialise in practice, are useful components of the assessment of the resilience of the financial system.

Besides this type of bottom-up stress-tests – which are based on the work conducted by individual financial institutions according to the guidance by authorities on stress scenarios – we need to also conduct top-down macro stress-tests conducted by the authorities on the basis of all the available information. Such top-down macro stress-tests should be conducted with the view to complement and cross-check the results of bottom-up tests and assess, in particular, how the identified risks should be prioritised – a task which has been formally entrusted to the ESRB.

Challenges are substantial, but progress is being made with a view to constructing robust models to cover and replicate interlinkages within the financial sector and ascertaining how they may be activated and play out under conditions of stress. This reflects not only the structural features of financial institutions – namely, which institutions are heavily exposed to each other and under which conditions such exposures can impair their viability, with ripple effects through the system – but also the interrelationships among the risk factors at the starting point of the analysis. In a real world situation, more than one risk factor tends to crop up at any one time, for example, at present, weak macroeconomic conditions and financial sector fragilities. But modelling a combination of several risk factors poses some challenges, both in terms of data and modelling complexities. For instance, we need to use models that allow us to identify the impact of each risk factor in isolation (e.g. to support a risk prioritisation view), while also being able to account for the overall effects of risks in combination.

Databases with the necessary information on individual financial institutions also need to be developed to allow the implementation of the top-down macro stress-tests.

Furthermore, macro stress-testing models, being the workhorse of systemic risk assessment, tend to provide an evaluation of the severity of the risks that is confined to the banking or financial sectors. This applies even to models that allow for a certain degree of interaction between financial institutions, and between these and the real economy. Risk assessments should also incorporate, to the extent possible, a view on the potential magnitude of risks which could spread via plausible propagation channels. Contagion and spillover models can be of use in this context, for example, in the analysis to evaluate the impact of specific failures within the financial system or in the assessment of the transmission of instability across sectors in the economy.

These are very ambitious goals requiring substantial analytical investment in the areas of macro-prudential analysis and research. In preparing its support to the ESRB, the ECB is making efforts to respond to various elements in this vast list of analytical requests, alongside other members of the ESRB and a number of national and international bodies with competences in the macro-prudential.

3. Information base

Now, while challenges remain on the analytical side, it goes without saying that the reliability and quality of the output of these models crucially depends on the quality of the data input. This applies to all models, including those regularly run at your institutions which provide inputs to daily or longer-term strategic decisions. In the same vein, of paramount importance for the identification of risks is a comprehensive, high-quality information base.

At the global level, the G20 and the Financial Stability Board are engaged in considerable efforts, to which the ECB is contributing, in order to reduce the data gaps identified in the aftermath of the crisis. In this vein, an important element of the ECB's preparatory work to support the ESRB consists of expanding and enhancing macroeconomic and financial statistical databases for macro-prudential purposes at the level of the EU. In this respect, close collaboration with the national authorities and the future ESAs is ongoing so as to ensure the ability to perform risk-focused analyses with adequate detail and scope in terms of, for example, country granularity, financial sector coverage and data frequency.

The private sector is also contributing, and could contribute more, to enhance the quality of the information base on which macro-prudential analysis will be based by continuing to enhance the transparency and granularity of individual reporting. This applies, in particular, to the large, complex and interconnected institutions on which a substantial part of the macro-prudential analysis is likely to be centred, as these institutions tend to contribute significantly to the level of risk of the overall system. The combination of better firm-level and macro-financial statistical information would also likely contribute to inform risk management decisions, as well as to enhance firms' own stress testing frameworks.

But not all information needed is of a quantitative nature. A well-functioning macro-prudential framework needs the support of market participants, also in qualitative terms, as rigorous monitoring of systemic risks will require continuous market intelligence. Contact with market participants will be essential for detecting important trends, such as growing financial imbalances, convergence of business models, similarities in investment strategies and innovations in financial instruments. Information gathered via market intelligence could, for example, be valuable in capturing market developments and perceptions not yet apparent in the most recent data and complement more quantitative-based surveillance work. It will also allow combining accounting-based information on the banking and financial sectors at large with firms' risk management views and their perception of the main risks further down the road. As such, in setting up an effective EU-wide risk surveillance process, importance is being given to the establishment of a structured dialogue with the financial industry focused on financial vulnerabilities at the system-wide level. It could take place on a regular basis both among high-level representatives and at the working level.

4. Towards a more stable financial system

This brings me to the last part of my remarks today.

The move towards a more stable financial system has been set in motion on a number of different fronts. I mentioned the enhancement of macro-prudential analysis and policy with a view to identify, in a timely manner, risks of a systemic nature and to respond with warnings or targeted policy measures to address them. This was at the centre of my talk, since this is where the ESRB will play an important role in safeguarding financial system stability at the EU-wide level.

Another dimension that will be at the core of this conference today are the prudential measures to increase the resilience of the banking sector over the coming years so as to increase firms' ability to withstand shocks and to reduce the overall vulnerability of the system. These include measures of both a micro-prudential and a macro-prudential nature, forming a comprehensive package of capital reforms and the new global liquidity standard. Banks loss-absorbing capacity will be reinforced by regulatory capital consisting of common equity and including two capital buffers: the capital conservation buffer and the countercyclical buffer, addressing macro-prudential risk in a time-varying fashion. Market risk, counterparty credit risk and securitisation risk rules have also been revised to ensure that risks are adequately captured. To limit model risk and the build-up of excessive leverage on and off the balance sheet, a non-risk based measure – the leverage ratio – has been introduced. On the liquidity framework, two key ratios have been put in place to enhance liquidity buffers in short and longer-term horizons, with the aim of reducing funding vulnerabilities and increase overall resilience to liquidity drains.

Here, we should bear in mind that, to a large extent, underlying the new regulatory framework is a better understanding of the concept and measurement of systemic risk, reflected in relatively simple and operational measures to address it. The aim is to have better regulation as a result of the combination of micro-prudential and macro-prudential perspectives, rather than more regulation per se.

Without pretending to be exhaustive, let me just refer to private sector initiatives which will also contribute to the overall soundness of the financial system. These comprise initiatives in the area of financial market infrastructure, such as the establishment of central counterparties for over-the-counter (OTC) derivatives clearance. Sound market infrastructures with appropriate risk management frameworks should mitigate counterparty risk and contribute to restoring trust in the financial system in the years ahead.

The role of the financial sector in constructing a more stable financial system is also critical with respect to disclosure. More disclosure in firms' financial reporting and better quality of publicly available firm-level data should enable a better assessment of counterparty risk and for contagion via direct and indirect channels. For macro-prudential analysis, enhanced disclosure will allow a better understanding and measurement of where systemic risk might be via the construction of more accurate indicators of aggregate leverage, correlation and concentration of exposures to specific asset classes and of a firm's level of interconnectedness, for example. Furthermore, for financial market players, better quality of information on a counterparty's financial condition should also contribute to enhancing in-house stress testing and strengthen firms' risk management systems. This could enable financial institutions to improve their forward-looking capacity in decision-making, resulting in them taking corrective measures with sufficient lead time and being more resilient to market tensions should they arise.

Concluding remarks

The financial sector has an important stake in a stable financial system and therefore in a well-functioning macro-prudential oversight and policy framework. In my remarks today, I have referred to the main areas in which the ECB and the central banking community are investing in order to operationalise the new macro-prudential oversight function entrusted to the ESRB.

In this process, the industry needs to be closely involved in risk detection and overall surveillance work, as information and insights from market participants will be essential inputs. We also expect the industry to pay close attention to the macro-prudential views that are communicated by the ESRB, among others, stemming from regular systemic risk assessments. Although each institution may not, per se, be able to create disruptive market conditions – at least in normal times – as the financial crisis has shown, the collective positions of the financial industry can have severe implications for financial stability, possibly with repercussions in the broad economy. In this regard, we will send messages to the industry that we trust will be heeded.

Efforts are also underway to ensure close cooperation between central banks, supervisory authorities and the ESAs so that risk assessments combine micro and macro-prudential perspectives and are of high quality and rigour. This should act as an important crisis prevention tool, also enabling the ESRB and the ESAs to respond in a timely fashion with policy measures aimed at addressing specific risks should this be deemed necessary. We are determined to make the new framework work in an efficient way to ensure financial stability in the European Union.