Jean-Claude Trichet: Macro-prudential oversight and the future European Systemic Risk Board

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the European Banking Congress, Frankfurt am Main, 19 November 2010.

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Ladies and Gentlemen,

It is a pleasure for me to participate in the European Banking Congress.

We are meeting at a very important time for Europe's financial system, of which so many senior representatives are assembled here.

This is also a very important time for the European economy and for the governance of the euro area.

Looking at the current situation, we have to be very clear as to what the issues are and where the solutions lie.

As its name suggests, Economic and Monetary Union has two attributes: one is "Economic" and one is "Monetary."

The "Monetary" attribute refers to the ECB, its mandate and its independence. I will come to this in a moment.

The "Economic" attribute comprises the fiscal regime enshrined in the Stability and Growth Pact; the national frameworks of economic policy; and the system of mutual surveillance.

The developments we are currently witnessing in Europe's economy have to do with its "Economic" functions. They have essentially three origins: unsound fiscal policies in a number of member states; inappropriate macroeconomic policies in a number of member states; and overall an inadequate system of surveillance by all member states.

This is the triangle that provides the perimeter of the current situation.

There is a solution to these three elements, and this consists in: first, ensuring sound fiscal policies in each and every member state; second, setting responsible macroeconomic policies; and, third, designing and adhering to a far more effective system of surveillance.

The ECB stands alongside the citizens of Europe. We understand their concerns about the governance of the euro area because, just like them, we are focused on the medium term.

That is why we call for a very ambitious reform of euro area governance – a reform that will address the root causes of the current situation and make it simply impossible to happen again.

I also have good news. This good news is that all the efforts to strengthen the economic attribute of our union will be supported by a monetary policy that will ensure price stability or, as you say in German, *Geldwertstabilität*.

As I mentioned, the "Monetary" attribute of EMU refers to the ECB, its mandate and its independence. By now, after almost 12 years, we also have a track record. As you know, the most important issue for a currency is to keep its value. There is one single measure for this, which is the average inflation rate over a medium or long-term horizon. This is how we measure price stability. I will be very precise. The average annual inflation rate in the euro area since the inception of the euro almost 12 years ago has been 1.97%. The European Central Bank has therefore been fulfilling its mandate, which is to keep inflation below, but close to, 2% over the medium term.

With all the challenges we have faced since 1999 – the cash changeover, the oil price spikes, the internet bubble, the turbulences in the aftermath of 11th September and, of course, the global financial crisis – maintaining price stability is a notable achievement.

What is more, looking ahead, inflation projections and inflation expectations are well anchored in line with price stability.

The launch of the ESRB

My main topic for today is macroprudential oversight and the new body that the European Council and the European Parliament have decided to create: the European Systemic Risk Board or ESRB. The legislation has been finalised yesterday and the ESRB will soon become reality.

I am honoured to speak to you today not only as president of the ECB but also in my future role as Chair of the ESRB.

The new European body will be part of the new European System of Financial Supervision and it will be located here in Frankfurt. The city can therefore be proud to host three European authorities: the ECB, the European Insurance and Occupational Pensions Authority (EIOPA) and the ESRB.

The function of the ESRB will be to provide macro-prudential oversight of the European Union's financial system. It will bring together the governors of the national central banks, the new European Supervisory Agencies (ESAs), the European Commission and the national supervisory authorities of all 27 member states.

The establishment of the ESRB was first recommended in February 2009 in the report of a high-level group chaired by Jacques de Larosière. The new institution is backed by a remarkably strong consensus between the European Commission, the European Council and the European Parliament. In the Parliament, the legislation underpinning the establishment of the ESRB was approved with an overwhelmingly large majority of 80%. This gives a strong backing to the ESRB and its mission.

The ECB will contribute to establishing the ESRB as a credible and effective body. Concretely, the ECB will host the Secretariat of the ESRB, thereby making it operational and providing analytical, statistical, logistical and administrative support.

But whilst the ESRB Secretariat will be located at the ECB, the ESRB will be a separate body, distinct from the ECB. The establishment of the ESRB will not affect the mandate and the functioning of the ECB's statutory role in monetary policy.

The establishment of the ESRB will be a landmark event in how Europe deals preventively with systemic risk. It forms part of wider developments across the globe, including in the US with the newly created Financial Stability Oversight Council (FSOC). Very much like the ESRB, this council is a collaborative body bringing together the relevant US authorities with the aim of identifying systemic risk and responding to threats. We will aim for close cooperation with the FSOC and other authorities for macro-prudential oversight.

The case for macro-prudential oversight

So what exactly is macro-prudential oversight? In many respects, it is the missing link between the different approaches of a central bank – which has such an important stake in stability at a macro level – and a financial supervisor – concerned with the financial soundness of individual market participants.

The de Larosière report argued pointedly that before the crisis, supervisory arrangements, whilst concentrating on the supervision of individual firms, were placing too little emphasis on the stability of the financial system as whole. Indeed, until the late 1990s, the dominant view in policy circles was that if individual institutions were financially sound, the financial system as a whole would also be necessarily sound.

We now know that relying only on micro-prudential supervision to ensure financial stability suffers from the fallacy of composition. What is true for a part, or even for all parts, is not necessarily true for the whole.

Amongst other elements of systemic risk, inter-linkages between institutions, correlated and concentrated exposures to risk, as well as herding behaviour may contribute to a destructive dynamic between institutions, markets and infrastructures. This would ultimately threaten the stability of the whole system.

Putting macro-prudential oversight into practice

Putting macro-prudential oversight into practice raises two questions: who should be charged with macro-prudential oversight and how it should be performed?

Let me start with the question of “who”. In most countries central banks play an important role in financial stability. Because of their monetary policy function, central banks have an in-depth knowledge of the financial system. They are independent anchors for monetary stability. They also have a clear interest in financial stability because of its beneficial impact on the macroeconomic environment. And, last but not least, central banks are the ultimate source of liquidity.

For all these reasons, central banks often have an explicit mandate in the area of financial stability. But typically this mandate is formulated in very general terms, and it would have been written before growing recognition of the key role of macro-prudential oversight.

Financial stability is not and cannot be exclusively an issue for central banks, namely the ECB and the European System of Central Banks. It must be shared with micro-prudential supervisors. They have a key role, because stable institutions are an essential and necessary condition for achieving financial stability. This is also the reason why the ESRB and the ESAs will form together a European System of Financial Supervision (ESFS).

So in the analysis of systemic risk, the three ESAs will also have an important role to play, both on their own and within the ESRB. In collaboration with the ESRB, they will develop a set of indicators to identify and measure systemic risk. On their own, they will further draw up guidelines and recommendations for individual financial institutions to take account of the systemic risk they pose. And they will need to ensure that they have the capacity to respond effectively to emerging systemic risks.

On the question of “how” to do macro-prudential oversight, the main tools that the ESRB will have at its disposal are warnings and recommendations. As we know, the strength of the so-called “soft law” can be quite significant, notwithstanding the lack of direct enforcement power. When risks have been identified and appear to be large, the ESRB will issue precise risk warnings. When appropriate, it will complement warnings with recommendations for remedial action and indications of the risks of inaction. We assume that the addressees will give careful consideration to the measures the ESRB will propose.

I am confident that the ESRB will quickly develop its credibility through its work, its warnings and its recommendations. Its authority will draw on the quality of its analysis and its deep understanding of the functioning of the financial sector.

Implications for the financial industry

I have described the rationale for macro-prudential oversight and the practicalities of establishing the ESRB. What are the implications for the financial industry?

The national supervisory authorities will remain the direct interface for financial firms on micro- as well as macro-prudential issues. As mentioned in the EU regulation, the ESRB's warnings and recommendations will be directed – I quote from the Regulation – "to the Union as a whole, or to one or more member states, or to one or more of the ESAs or to one or more national supervisory authorities". Recommendations can be also directed to the European Commission, in the area of the elaboration of new EU legislation. Nowhere do the legal texts mention that the ESRB will address individual firms in its warnings and recommendations.

But the industry also has to be aware that with the ESRB and the overall European System of Financial Supervision we will be in a different environment. Following deliberations by the ESRB, competent authorities may decide to utilise the tools that are designed to counter the build-up of risk in the financial system. Their tools, as you know, include possible capital add-ons, countercyclical capital buffers or maximum loan to value ratios.

One of the first tasks of the ESRB could be to review existing instruments and those that are being created at the global and the European levels. More generally, micro-prudential instruments that are well known in the banking sector, would be calibrated and used with a macro-prudential orientation.

I want to refer here to the concrete example of counter-cyclical capital buffers. In July, the Basel Committee on Banking Supervision released its proposal for countercyclical capital buffers. The aim of such buffers is to make banks build up capital when system-wide risk is increasing following excessive credit growth. The buffers can then be drawn on when risks materialise and credit losses occur.

The case of counter-cyclical buffers is particularly interesting, first because it is one of the tools with a clear macro-prudential orientation and second, because the ESRB and the European Banking Authority (EBA) could join forces for implementing the framework in Europe. This is suggested by the European Commission in its recent consultation paper on the potential role of the ESRB and the EBA in defining policies and standards that national authorities should follow.

Concluding remarks

Let me conclude. I see three reasons to expect relevant changes with the start of macro-prudential oversight in Europe. The first and most important reason is that better supervision should contribute to a more stable financial system. This is as much to the advantage of all players in the industry as it is to everyone in the wider economy.

Second, integrating a macro-prudential perspective should lead to better regulation. In essence, systemic risk is the outcome of the actions of individual market players for the system as a whole. Regulation, which traditionally focuses on individual market players, can be improved by taking account of this potentially disastrous side-effect. Initiatives such as the counter-cyclical buffers and possible capital surcharges or other equivalent measures for systemically important financial institutions fall into this category.

The third reason for welcoming the ESRB is that macro-prudential supervision could improve financial firms' own risk analysis. I trust that it will provide an incentive to internalise the system-wide dimension in the industry's own risk models and stress-testing.

Ladies and gentlemen, less than two years after the publication of the de Larosière report, Europe will have its own macro-prudential authority up and running. This is a remarkable achievement. We are now moving from designing the framework to implementing it. We have to make the enhanced resilience of the financial system our highest priority.

I thank you for your attention.