Jean-Claude Trichet: Taking stock on financial reform

Opening speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Frankfurt Finance Summit, "The future of risk management and regulation: smarter regulation, safer markets", Frankfurt am Main, 23 March 2011.

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Ladies and Gentlemen,

I am very pleased to be able to open this conference here at the House of Finance in Frankfurt.

Frankfurt now hosts *three* European institutions: the European Central Bank (ECB), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB).

This city is now the home not only of Europe's monetary authority, but also of important supranational responsibility for supervisory matters. With the EIOPA and the ESRB, Frankfurt hosts half of the European bodies in the new European System of Financial Supervisors, with the other two European Supervisory Agencies (ESAs) – the European Banking Authority (EBA) and the European Securities and Markets Authority – based in London and Paris respectively.

I have looked with great interest at today's programme, which is of exceptional quality.

In my opening remarks, I would like to lay out a scheme of the building blocks of the financial reform that is still in progress.

I believe that when we look back in a few years on the financial reform following the global crisis, we will identify three main building blocks:

The first is banking regulation. The global community is making a big step forward here. It has made the right diagnosis and, in the Basel III framework, drawn the appropriate lessons. My friend Nout Wellink is chairing the Basel Committee; I myself have the privilege of chairing the Committee of Governors and Heads of Supervision, which provides guidance to the Basel Committee.

The second building block is regulation of the financial markets. Here, reform must ensure much greater transparency for the various market segments and products, ensure sufficient competition in all markets, and attenuate as much as possible the pro-cyclicality that derives from information asymmetries, structural features such as ratings and market phenomena such as herding.

The third building block is macroprudential oversight. This new discipline focuses on the interactions between the various parts of the financial system and between the financial sector and the real economy. New institutions, including the ESRB and equivalent oversight committees around the world, will pursue the task of identifying sources of systemic risk, issuing early warnings and recommending remedial action.

The birth date of macroprudential oversight in Europe will probably be identified as the start of this year but it was originally conceived in 2009 through the work of Jacques de Larosière and his high-level group, which included my friend Otmar Issing. Eighteen months from policy design to institutional establishment is a remarkable achievement. It was made possible by thorough groundwork as well as excellent transposition by the Commission and very rapid decisions by the European Parliament and the European Council. I feel very honoured to chair this new body, the ESRB.

Let me focus on each of these three building blocks in turn, starting with banking.

I. Banking regulation and Basel III

Basel III, which constitutes the cornerstone of regulatory reform for the banking sector, provides for higher minimum capital requirements, better risk capture, a stricter definition of eligible capital elements with a particular focus on common shares and more transparency.

The revised regulatory framework allows appropriate transition periods for financial institutions to adjust to the new standards, thereby ensuring a smooth phasing-in of the new regulatory requirements without compromising the nascent economic recovery. By 1 January 2015, the minimum capital requirements for common equity Tier 1 and total Tier 1 capital will gradually be raised up to a level of 4.5% and 6.0%, respectively. This gradual phasing-in of minimum requirements will be complemented by an appropriate observation period for the non-risk-based leverage ratio and the liquidity standards. The ESRB, together with the EBA, will play an important role in policy setting and implementation, with the former contributing to ensuring consistent implementation of the policy framework throughout the EU. We are just beginning that process.

In addition to the necessary transposition into national or European law of the Basel III rules, there are two issues that still need to be addressed: systemically important financial institutions; and capturing the so-called shadow banking system within the regulatory framework.

Work is in progress on systemically important financial institutions, in particular in the Financial Stability Board. The main objectives are to reduce the probability of failure of such institutions and, in case a failure occurs, to reduce the impact on the financial system.

In September 2010, the Governors and Heads of Supervision agreed that systemically important financial institutions should have additional loss absorbing capacity. Work is currently underway on how to define institutions that are systemically important, and how to determine the capital surcharges, contingent capital and other elements to limit systemic fallout.

With the shadow banking system, we have to ensure that tighter regulatory rules do not provide incentives for financial institutions to shift their activities to unregulated areas. Oversight of the shadow banking sector needs to be improved. The FSB has already done valuable work – supported by the ECB – on shadow banking. In this context, the ECB is providing the Financial Stability Board (FSB) with flow of funds data on the composition of the financial sector concerning the euro area. The concrete challenges lie in the establishment of a suitable definition of shadow banking and outlining possible regulatory options to address the risks posed by this sector.

Given the background of the crisis, regulatory effort on financial institutions has focused on banking, but there is important work underway also for other financial institutions, such as the further specification of the capital adequacy regime for insurance companies (“solvency II”).

II. Market regulation

Let me turn to the second building block, namely regulation of financial markets. This area is as challenging and as complex as banking.

The main observation we have to draw from the crisis is that the risks in market returns were not mainly exogenous, coming from the stochastic variation in the real economy. They came from financial risk itself. The financial structures that we thought were in place to assess, absorb and neutralise risk were either dysfunctional or worked to magnify volatility.

Key factors in creating this risk were opaque financial structures, particularly vulnerability to contagion and domino effects, and pro-cyclicality in financial markets.

The lack of transparency in many financial instruments meant that some market players could exploit – for their own, private benefit – information that was not generally available.

Pro-cyclicality acts as a formidable accelerator of financial trends. Two important factors that drive such amplification are distorted incentives and herd behaviour.

The role of distortions in economic incentives is probably better known as it had traditionally been widely appreciated even within neo-classical modelling. By comparison, herd behaviour as a driver of pro-cyclical patterns in financial markets still needs a thorough explanation.

It is difficult to rationalise herd behaviour. There are two possible explanations. One is the significance of a market player's evaluation of his or her performance relative to the rest of the market. This is reminiscent of Keynes' famous beauty contest analogy. To be successful in this environment, individual participants do not form their own opinions, but follow the general mood prevailing among market participants. Everybody seeks to ride the wave created by general sentiment, hoping to step off before the general sentiment turns.

The second explanation is that global markets are in fact less atomistic than we think. Indeed, despite globalisation, increasing market concentration was already a long-term trend before the crisis. Derivatives activity in the US banking system, for example, is dominated by a small group of large institutions. And, of course, the market for credit ratings is famously dominated by three signatures, which act as standard-setters for an enormous volume of transactions.

Many regulatory initiatives are underway to remedy these issues, including work on OTC derivatives, ratings agencies and alternative investment vehicles. But addressing these challenges could also be supported by reorienting significant resources in research. In particular, I would welcome an enrichment of thinking in economics and finance, by including new approaches that do not necessarily rely only on the notions of equilibrium, universal rationality and efficiency.

Inspiration from other fields, such as the natural sciences, may be particularly pertinent. I am thinking for example of market movements from stability to instability, from tranquillity to turbulence. In physics such phenomena are described as phase transitions. When some factors exceed a critical level, a system behaves qualitatively differently from a situation when the factors stay below this level.

Let me now turn to the third building block of regulatory reform, macroprudential supervision.

III. Macroprudential oversight

As my earlier remarks have suggested, the financial crisis has been revealing in many respects. It has revealed the fallout from the failure of large financial institutions. It has revealed the fragility of the financial system to features and trends that cut across institutions, markets and infrastructures. And it has illustrated the amplitude of the consequences of the adverse feedback loop between the financial system and the real economy.

All these three elements are key features of systemic risk: first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the financial system; and third, the close links with the real economy and the potential for strong feedback effects.

The crisis has revealed the fundamental importance of systemic risk. Of the three elements I have mentioned, contagion and the link to the real economy are the least novel in the current episode. The most unexpected element has been the rigour with which systemic risk has been triggered by the collective behaviour of financial institutions and the ways in which they interact in financial markets.

The main new avenue to explore is therefore to improve our understanding of interconnectedness in the financial system, both via the direct links between financial institutions and the indirect ones created in financial markets. Everybody now sees that major risks can emerge from within the financial system itself. It was not the real economy that threw the financial system into disarray, but the reverse.

Endogenous risks – risks that emerge from within the financial sector – can have many causes. They may arise, for example, because large parts of the system rely on the same sources of funding, or because they have similar exposures – to rising financial imbalances, to currency mismatches and to widespread mis-pricing of risk.

We have also seen that turbulence can arise from relatively modest initial shocks. The system is so interconnected that what looks stable can turn out to be "meta-stable", which means potentially highly instable. Snow on mountain slopes can be meta-stable, looking pristine and tranquil yet turning into an avalanche after only a minor disturbance.

For all these reasons, we have established a new framework of macroprudential supervision as have our counterparts elsewhere, including in the United States with the new Financial Stability Oversight Council. In the case of Europe, there is still one more reason for macroprudential oversight, and that is the single European market.

Cross-border and cross-sectoral financial integration within the EU is fostered by competition, freedom of establishment and the free flow of capital. The single financial market is a crucial component of the overall single market project, and macroprudential supervision should enhance the resilience of this market.

So how exactly will the new discipline of macroprudential oversight be conducted? Financial stability is not an issue exclusively for central banks. Micro-prudential supervisors have a key role, because stable institutions are an essential and necessary condition for achieving financial stability. This is why the ESAs and national supervisors together with the central banks are members of the ESRB and why the ESRB and the ESAs form the European System of Financial Supervisors.

The ESRB's main tasks are threefold: to identify and prioritise systemic risks; to issue early warnings when significant systemic risks emerge; and to issue policy recommendations for remedial action in response to the risks it identifies.

The ESRB will not focus on individual institutions, individual countries or individual macroeconomic issues – it will take a strong horizontal focus, across countries, across sectors and across the boundaries between the financial sphere and the real economy. Interlinkages and spillovers should be key terms in its analysis.

To achieve these tasks, the ESRB is drawing on information from many sources, including strong analytical input from its members; intelligence gathered from financial system participants; and the data necessary to understand the nature of interlinkages that define the financial system. ESRB analysis must be broad-based covering potentially any aspect of the EU's financial system – markets, institutions and infrastructure.

The ESRB is being established at a time when the concerns of markets and policy-makers about short-term vulnerabilities seem to prevail over perceptions of medium- and longer-term risks. This confronts the ESRB, as well as other macroprudential bodies around the world, with specific challenges. The ESRB needs to consider what activities to initiate, well before a fully-fledged macroprudential policy framework is developed in the medium term. At the same time, it must develop this policy framework, for which no template exists and for which the analytical background captures only parts of the tasks.

In the medium term, the ESRB and the macroprudential authorities of the 27 EU countries will need operational policy frameworks with specific instruments. The ESRB is ready to support – at a technical level – the work that European institutions have started to design the implementation of countercyclical capital buffers. Other macroprudential instruments are also desirable. Work on these issues has been initiated. For example, new rules on margins and collateral should counteract the fluctuations of the cycle. The specific capital requirements for risk-weighted assets might also be adjusted over the cycle.

When these macroprudential instruments are established, possibly around the middle of this decade, the authorities will finally have tools to mitigate the pro-cyclical behaviour of financial

players. Authorities will set part of the regulatory requirements not against the solvency or liquidity situations of single institutions, but taking a view of the macroprudential cycle.

Other instruments will be needed to address interconnectedness, including the most complex and innovative elements of market functioning. One specific focus of authorities is to ensure that efficient and secure central counterparties are created to reduce risks in OTC markets.

Concentration risks produced by increasingly large financial institutions in trading and post-trading will also need to be addressed. Finally, authorities will need new regulatory instruments to keep pace with the impact of new technologies – including high frequency trading, algorithmic trading and the new universal trading platforms, which are gaining ground very rapidly.

Last week, the ESRB selected the members of its Advisory Scientific Committee to provide advice on analytical issues. We have also established the Advisory Technical Committee, which assembles experts from all central banks. The institutional set-up is completed and the ESRB will now focus on its substantive tasks, of which we will have a substantive review in June this year. Combining a focus on short-term risks with the medium- and longer-term perspective will be the major challenge.

Conclusion

Let me conclude. I believe we are now about halfway through the comprehensive reforms that the crisis has called for. We have achieved a blueprint of more stringent bank regulations that includes more loss-absorbing capital, better risk coverage and limitations for undue leverage. Countercyclical capital buffers are meant to lower pro-cyclicality.

The oversight of financial institutions as well as markets and market infrastructure are being strengthened, and the organisational structure of financial supervision is being overhauled.

But much remains to be done. The most important aspect is the implementation of these reforms. Moreover, the issue of systemically important financial institutions requires further reflection, and oversight of the proper functioning of financial markets in a way that avoids undue volatility, excessive influence of dominant players and oligopolistic market structures, while reinforcing transparency, needs to be addressed resolutely.

Such understanding would be enhanced by greater focus in academic research on analysis of the intricate interactions in complex financial systems.

The appropriate benchmark for the financial system is whether it is providing appropriate financing to the real economy in a stable and sustainable way. Thereby, and thereby only, will it make a valuable contribution to our economy.

Thank you for your attention.