Yves Mersch: Financial crisis and the challenge of supervision

Welcome address by Mr Yves Mersch, Governor of the Central Bank of Luxembourg, at the ESE (European Supervisor Education Initiative) Conference 2011: "Financial crisis and the challenge of supervision", Luxembourg, 28 September 2011.

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Ladies and Gentlemen,

It is a great pleasure and an honor to host the 2011 European Supervisor Education Initiative conference on Financial Crises and the Challenge of Supervision here in Luxembourg. I am pleased to note that so many participants from the supervisory and central banking community are attending. I am convinced, that stimulating input by the distinguished discussants will be beneficial to all participants. The Banque centrale du Luxembourg, given its mandate of prudential liquidity supervision and its role in macro-prudential policies, has joined the European Supervisor Education Initiative in 2010.

Against the background of renewed vulnerabilities and turbulences in markets, the subject of the conference is indeed very timely. Liquidity risk, together with sovereign and funding risk constitute for the time being the main threats to the EU-banking system. The recent intensification of tensions in the sovereign debt market has led to contagion risk of systemic nature.

From a supervisory perspective, let me redraw that the past financial crisis have evidenced the fact that micro-prudential supervisory instruments and tools alone, if used in an isolated way, may no longer be sufficient to address the challenges posed by financial instability.

The need has been highlighted to restructure regulation and supervision and to go beyond a purely micro-prudential approach in this regard. Focussing on the development of a macro-prudential framework should better position authorities to contribute to reducing pro-cyclicality and improving the financial sector's resilience to adverse shocks.

In response to the regulatory challenges, the European System of Financial Supervision (ESFS) has been established, under which the European Systemic Risk Board (ESRB) has been made responsible for the macro-prudential oversight of the financial system as a whole. The work of the ESRB, which is founded on close cooperation between central banks, national supervisory authorities, the European Supervisory Authorities (ESAs) and policy makers, will contribute to the mitigation of systemic risk within the financial system.

However, despite the significant progress in institutional architecture at the European level, crucial areas within global and national financial systems remain fragile and vulnerable to unexpected shocks. All countries face a varying degree of challenges. In Luxembourg we still have significant gaps, particularly with respect to institutional reforms and the adjustment of our model of supervision. In this regard, I am aware that there is no perfect supervisory model, nevertheless, we must try to profit from the recent experiences of other neighbour countries in order to mitigate systemic vulnerabilities and enhance financial stability. As you know, different countries; U.K., Belgium, France and recently Switzerland, have adjusted their model to be more integrated.

So it would appear self-evident that central banks, given their role as lenders of last resort and their responsibilities in monetary policy and liquidity management, should play a key role in safeguarding financial stability. However, the lender of last resort might be the most important backstop during periods of financial turbulences, nevertheless this should not be a "free lunch". In order to fulfill their responsibilities effectively, central banks should be equipped with a clear and independent macro-prudential mandate and toolbox to assess and mitigate macro-prudential risks at the systemic level. This proposal is coherent with the

recommendations of the de Larosière report which attributed an umbrella role to central banks in the supervisory framework.

In this regard, it must be assured that national macro-prudential authorities have the flexibility to adjust regulatory requirements over the business cycle. Thus, I welcome the Commission's proposal regarding CRD IV in particular, the countercyclical capital buffer. However, the macro-prudential regime must find a balance between preserving national flexibility – as the business cycle varies between European countries – and maintaining a level playing field so as not to distort competition within the Single Market.

As I mentioned, aside from the institutional arrangements, many challenges remain to be resolved. The G-20 and the European Commission have taken some initiatives in addressing the regulatory deficiencies highlighted by the crisis. These include Basel III, OTC derivatives, the shadow banking system, high frequency trading, central counterparties (CCPs) and crisis resolution mechanisms, etc... Such proposals remain at an early stage and still face the challenges of jurisdictional realities.

Let me now focus on some specific issues that may arise under the new regulatory regime. With respect to liquidity, two new instruments have been proposed i.e. the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR). These quantities are intended to improve financial institutions' liquidity risk profiles and the resulting increase in resilience should help to mitigate funding and market liquidity risk. In combination with a more robust and efficient supervisory landscape, the new liquidity standards should also help to bolster internal liquidity risk management practices. This issue remains crucial as the recent sovereign debt turbulences have increased the level of liquidity pressure experienced by banks. At the same time, tensions in foreign currency funding for financial institutions have become acute and it seems to be important that these concerns be addressed within the context of the new regulation.

Going forward at the national level, the BCL has seen the need to incorporate these ratios into its current risk-based liquidity surveillance framework which relies on a combination of qualitative and quantitative elements. In addition, regular on-site visits and continuous off-site monitoring are currently combined with a five day forward-looking liquidity reporting by banks.

The BCL also sees the need to conduct surveys and studies in order to assess the liquidity situation of financial institutions. Indeed, with regard to the new liquidity ratios, an empirical analysis was performed in Luxembourg. The results revealed that a one-size fits all approach to liquidity supervision might not be appropriate given the diversity of banks' business models. Thus I wonder if it would more useful to complement the focus on financial institutions by taking into account their activities. Therefore, a maximum harmonized rulebook, disallowing flexibility on a national level, does not strike the right balance between efficient liquidity surveillance and increased resilience of banks. The issue of the maintenance of liquidity buffers at national level for host entities of cross-border banking groups shall deserve particular attention in this regard.

It is profoundly in the interest of all actors that these new requirements be implemented in a consistent and timely manner. During the transitional period however, further analysis is required in order to ensure an appropriate calibration. Unintended consequences due to restricting the ability of banks to manage their short and long-term liquidity or to undertake the maturity transformation process which represent the core of financial intermediary activities need to be weighed against the intended benefits.

Furthermore, care should also be taken to avoid incentivising banks to shift some of their activities to the non-regulated banking system; the so-called "parallel" or "shadow" banking sector. Currently, only preliminary information on the level of interconnectedness between regulated and non-regulated entities is available to supervisors. Additional work is needed in this regard, in order to improve the efficiency of financial regulation across markets and jurisdictions. Looking forward potential new risks stemming from micro-structural issues such

as UCITS exchange-traded funds and high frequency trading, which I mentioned before, need to be properly addressed.

Regarding the access of credit institutions to central bank funding, their eligibility should be based on their financial soundness, as assessed through their solvency and liquidity robustness. It is therefore of crucial importance for central banks to have access to relevant and detailed micro-prudential information and assessments on their monetary policy counterparts. Moreover, this assessment cannot be dissociated from prudential information on the banking group to which the respective counterpart belongs. This calls for an enhanced participation by central banks and their involvement both in the EU College of Supervisors and cross border stability groups.

Before I conclude, I think it would be appropriate to point out that the increased level of interconnectedness of financial systems and banking groups highlights the need for improved cross-border cooperation and crisis management.

Finally, let me mention human capital requirements as another key area which often goes, unmentioned yet is important for improving the quality and efficacy of supervision. By combining the competencies and skills of supervisors and central banks, the ESE initiative certainly contributes to enhancing the convergence of practices. Under this welcome initiative, the efforts of the Banque centrale du Luxembourg will continue to enhance the approach adopted by the ESE initiative.

Ladies and Gentlemen, I wish you a pleasant stay in Luxembourg, and an interesting and successful conference. I am sure the presentations as well as the panel discussions will include interesting and fresh ideas and insights from which all participants can benefit in their ongoing tasks, be it at local or cross-border level.