Jürgen Stark: Macro-prudential supervision and financial integration – the ESRB at 1

Diner speech by Mr Jürgen Stark, Member of the Executive Board of the European Central Bank, at the SUERF/Deutsche Bundesbank Conference 2011/IMFS – The ESRB at 1, Berlin, 8 November 2011.

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Ladies and gentlemen,

It is a great pleasure for me to be here this evening. The growing integration of Europe's financial markets and the financial crisis of 2007–2009 have raised important questions about the design of European banking supervision. If we had relied on effective macro-prudential oversight and policy instruments back then, one can argue that the social and economic costs of the crisis would have been much lower. Crucial improvements to the financial system were needed, and are still needed, to prevent and mitigate systemic risk. In particular, financial institutions should be allowed to fail without imposing unacceptable costs on the rest of society. Tonight, I shall reflect on the recent developments in European macro-prudential supervision and try to clarify our understanding of what European macro-prudential policy is and what it is not, and what it can achieve and what it cannot.

To start with, I would like to quickly review the root causes of the global financial crisis, which give you the background to why and how the European Systemic Risk Board (ESRB) was set up. Then I will dwell on the inherent tensions that exist between a need for financial integration within European Monetary Union (EMU) and the micro-prudential supervision and fiscal policies that have remained national competencies. Finally, I will take a critical look at the role, power and limitations of the European Supervisory Authorities (ESAs), which I see as significant steps in the right direction towards shaping a system that will ensure financial stability.

Let me begin by looking back. The causes of the recent crisis have been attributed to macroeconomic factors, to major weaknesses in corporate governance in financial institutions and, also, to an inadequate level of supervision and regulation. At the macroeconomic level, rapid credit expansion over a protracted period of time in a benign environment of low inflation, high growth and large and persisting imbalances fostered important leverage and maturity transformations, as well as a significant underpricing of risk. At the same time, at the microeconomic level, financial innovations were implemented in a manner that fostered wrong incentives, notably in the securitisation process, which should have helped, in principle, to better diversify and manage economic risk. The securitisation of assets made it possible for financial institutions to sell loans within complex and opaque financial products and to take them off their balance sheets. These financial techniques weakened incentives for the prudent screening and monitoring of credit risk and led to banks loosening their lending standards. Eventually, when the global financial system was thrown into crisis, many policy-makers were shocked to discover that they did not have the macro-prudential tools to deal with part of the financial system spiralling out of control. Up until then, the common view in policy circles had been that the whole financial system would be stable as long as its single parts were sound. The financial crisis painfully demonstrated how supervisory arrangements have not been sufficiently focused on ensuring the stability of the financial system as a whole. Therefore, to be able to monitor, assess and mitigate systemic risk, policy-makers have been working on creating new tools for a new policy area, namely giving a macro-prudential orientation to financial regulation and supervision.

The European Systemic Risk Board (ESRB) was established as the main body for macro-prudential oversight and surveillance of EU financial markets.

As you probably know, the European Central Bank (ECB) has close links with the ESRB. These include, first, a personal link: the President of the ECB also serves as the Chairperson of the ESRB. Second, the ECB provides logistical and administrative support by hosting the ESRB secretariat. And lastly, the ECB provides analytical and statistical support, collecting and processing information that feed into the ESRB's discussions.

Despite this, however, the ESRB remains a body that is quite distinct and separate from the ECB. The ESRB does not change in any way the functioning of the ECB's statutory role and its unambiguous primary mandate for delivering price stability. The new institutional set-up, and the ECB's role in it, rests on solid institutional and legal foundations. The ECB has participated closely and constructively in the legislative process leading to the establishment of the ESRB. It has thus focused on establishing in Europe the most effective and robust macro-prudential supervision set-up possible to prevent and mitigate systemic risk.

The question remains, however, as to whether, within this new macro-prudential framework, there might not be some tension between inter-connectedness born out of the growing integration of financial markets and matters of national competencies. Let me look at two of the challenges we currently face.

First, increasing financial integration, both in Europe and globally, has had important implications for the cross-border propagation of systemic risk. Since the introduction of the euro, we have seen growing integration of European financial markets. This has been illustrated by a significant convergence in interest rate differentials in wholesale and interbank markets, by a significant degree of convergence for the cost of capital for equity and debt issuance across countries and, by a gradually decreasing home bias in the composition of asset classes in most regulated investment funds. This closer integration has been facilitated by the growing importance of the euro as a reserve currency, as well as by the rapid technological advances that have enabled markets to operate more easily in a cross-border environment. As financial markets have become more inter-connected, the structure of banking markets and their management has also changed significantly. Large banking groups have been created from a growing number of cross-border bank mergers. Today, many banking groups have major operations in multiple jurisdictions, where they can pose systemic risk to a host banking system.

At the same time, over the last decade, EU legislation has been growing dramatically in scope and coverage for many areas and segments of financial markets. However, the implementation and enforcement of this legislation has been ultimately left to the discretion and authority of supervisors in the individual Member States, based on the principle of home country control and mutual recognition. The recent financial crisis has clearly illustrated these substantial cross-border implications and the need for a more robust macro-prudential supervisory framework and micro-prudential supervisory regime.

The second challenge concerns another aspect of policy-making left to the authorities in the individual Member States: namely, of course, fiscal policies. A consequence of financial integration is that European banks are exposed to a wide range of risks in European government debt and not only to domestic sovereign risk. This implies that, in a crisis, distressed government debt tends to become a common liability for all governments, at least through the interdependence of banking system vulnerabilities across jurisdictions. The current sovereign debt crisis in Europe is proving to us that fiscal policy should be more grounded – in a similar way to monetary policy – within a rules-based framework with clear medium-term objectives. And for rules and sanctions to be fully credible, they should be stricter, automatic, and as free as possible from the political process, so that countries have the right incentives to address their problems. This calls for substantial improvements in the quality of fiscal institutions and policy frameworks in Europe.

All in all, a lesson to take from the current sovereign debt crisis is that there is an undeniable tension between, on the one hand, the need for financial integration to ensure a smooth functioning of Monetary Union, and, on the other hand, micro-prudential and fiscal competencies that have remained at the local level. And this tension has the potential to exacerbate the risk of future financial crises and hinder effective crisis management. We need bold steps towards a fiscal union. We need to go beyond and create a financial union. In one word, the crisis has clearly shown us that we need “more Europe”.

The new EU supervisory framework is actually based on two pillars: first, the ESRB for macro-prudential supervision and, for micro-prudential supervision, a second pillar comprising three different European Supervisory Authorities (ESAs) – one for banking, one for insurance and one for the securities markets. This framework provides a more consolidated and rational institutional design for linking the micro-prudential supervision of individual institutions with the supervision of linkages between institutions and within the broader system.

However, as the ESAs were only established at the beginning of 2011, they are too young for us to judge their effectiveness. Under the current framework, all supervisors in the Member States continue to be responsible for assuming their individual supervisory functions, but they have to report on their practices to the relevant authority. The ESAs’ regulations provide for a review of the new institutional arrangements by the European Commission in early 2014. Should the ESAs be deemed not to have adequate tools and powers, there may be a case for greater integration of the supervisory framework – including tools for crisis management and resolution. There may indeed also be some support for a single EU financial supervisor. The main argument for such an institutional consolidation is that given the growing financial “inter-connectedness” of Europe, a centralised supervisory body would promote a more efficient level playing field in supervisory practices. Moreover, it might enhance both the efficacy of supervision and the crisis management capabilities over credit institutions with a strong cross-border presence. Although there are obvious benefits of such a centralised institutional structure, there are also obvious concerns about the issue of national sovereignty.

Let me wrap up and conclude. By providing the basis for payments and by acting as the principal intermediary between savers and borrowers, the banking system plays a role similar to the electricity supply network as a vital part of the economic infrastructure. However, as recent experience has shown, if the stability of the system is undermined, considerable disruption can ensue, leading to considerable effects on social and economic costs.

For these reasons, financial stability may be seen as a “public good” which requires adequate regulation. Regulators need to tread a careful path between controls that ensure the stability of the financial system and over-bearing regulation, which would hinder competition and efficiency.

The new regulatory reform and the macro-prudential oversight now in place constitute an unprecedented achievement. At the same time, key challenges remain, in particular regarding the interaction between macro-prudential and micro-prudential authorities, especially against a background of growing inter-connectedness of financial markets and the sovereign debt crisis. Looking forward, the coming years will be crucial to judge the functioning of the new financial supervision framework, to assess the efficiency of the new tools and methodologies that are being developed as academic research progresses in this field, and to minimise and correct potential inefficiencies. The achievements made so far are clearly a major step towards creating a safer financial system, but further ambitious arrangements may be needed to enhance the robustness of our financial systems. Not only stricter fiscal rules and the creation of a fiscal union are needed, but it has to be complemented with a financial union.

Thank you for your attention.