Sabine Lautenschläger: Guardians of stability - central banks, supervisors and the quest for financial stability

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the Central Bank of Malta, Valletta, 12 October 2018.

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Ladies and gentlemen,

It is an honour to be here and to join in celebrating a birthday! This year, the Central Bank of Malta turns fifty. And throughout these past fifty years, it has helped Malta to navigate the sometimes rough waters of the international monetary system.

From the early days when it focused on exchange rate policy, to its efforts in bringing the country into the euro area in 2008, and since then, as part of the Eurosystem, the Central Bank of Malta has shown resilience and adaptability. So, I wish the central bank a very happy birthday!

But there is another birthday this year – a less happy one. It's a birthday that no central banker or banking supervisor can shy away from. Ten years ago, Lehman Brothers collapsed, setting off the financial crisis. Since then, financial stability has become a buzzword, and for many good reasons.

The instability in the financial system of 2008 had devastating consequences across the globe. In the end, it was not only costly for banks, investors and taxpayers. Many people also lost their jobs, their businesses and their homes. Events of such a magnitude not only alter the course of people's lives; they may alter the course of entire societies. The urgency for reforms was immediately clear. Something had gone badly wrong, and policymakers had a duty to find the causes and prevent this from ever happening again. To do so, they had to ask what, how and why.

But, I did not come all the way to Malta to give you yet another "lessons learned" speech. Instead, I would like to share some more thoughts on financial stability. Financial stability may have become a buzzword, but it is not a new concept. People have wondered in particular about the central banks' role in financial stability for as long as central banks have existed.

For the ECB today, the issue is still complex, but the answers are clear. The primary objective of the ECB is to maintain price stability. At the same time, it also has a contributory role in financial stability, as indicated by the Treaty on the Functioning of the European Union. The ECB monitors and assesses risks to financial stability, because turbulence in the financial system may weaken the ECB's ability to maintain price stability—the two are functionally connected. And since the crisis, the ECB also plays a role in maintaining financial stability through its competences in banking supervision and in macroprudential policy.

But going back in time, the relationship between the different functions of central banks have generated quasi-existential questions.

What a central bank is, can be defined by what it does.[1] And the "what it does" part mostly revolves around the question of whether a central bank cares about two types of stability.

The first is monetary stability: the creation of a monetary regime that can ensure price stability. The second is financial stability which, when central banking was born, was essentially the same as "bank stability". So, throughout history, the most popular definitions of "central bank" have revolved around their role in ensuring monetary stability, financial stability or both.

One of the founding ECB board members, Tommaso Padoa Schioppa, believed that both aspects mattered. To him, a central bank was defined by its role in safeguarding both price stability and financial stability.

As for financial stability, he argued that historically, a central bank's role in this realm was rooted in its DNA. First, the central bank was a bank. It was also monopolist in the provision of ultimate liquidity. And last but not least, it was a bankers' bank. It played a role in settling payments between banks.[2] And a well-functioning interbank market plays an important role for financial stability.

And he was of course not the only one to see the role that central banks played in financial stability as essential. From Walter Bagehot's book "Lombard Street" all the way to the work of Charles Goodhart, one function has been singled out to identify central banks: their role as lenders of last resort.

Take the Bank of England as an example. Even after becoming a monopolistic issuer of notes, it still operated as a profit-maximizing bank. Charles Goodhart argues that it did not become a true central bank until the second half of the 19th century, once it let go of profit-maximizing and took on the role of lender of last resort.[3]

And there is a similar story about the emergence of central banks on the other side of the Atlantic. This story roughly starts with the Panic of 1907: a series of bank runs and bank failures that devastated the US economy. In the absence of a public lender of last resort, a private citizen stepped in: JP Morgan. He called on a group of fellow bankers, and together they stopped the panic by providing loans to troubled banks. This episode eventually led to the creation of the Federal Reserve System as a public lender of last resort.

So, there it is: historically, some scholars saw financial stability as a central aspect of central banks' work. But of course, history can be seen from different angles. And that is also true for the history of central banks.

In fact, in explaining how modern central banks emerged, others have focused on monetary stability rather than financial stability. Their story starts with the introduction of paper money. Unlike commodity money, paper money does not have an intrinsic value; after all, it's just a piece of paper. So when commodity money gave way to paper money, a need arose for institutions that could guarantee a stable value of money.

It was central banks, of course, that could do so. They could issue a national currency and ensure its stability.[4] And here again, the Bank of England is seen as the first modern central bank.[5]

So what is it now that makes a central bank so special? What is it that sets it apart from other banks? Is it the ability to maintain monetary stability, the ability to maintain financial stability, or both?

Well, the truth is that they are sometimes hard to separate. It is hard to delineate when financial stability gets so important that it affects monetary policy and vice versa. And what's more, things are not as simple as they used to be. Today, innovations like online shopping, or global value chains, add to the complexity of maintaining price stability. And these days financial stability is about much more than just banks.

And yet, the central question remains. What should central banks do? What should their functions be? And what their objectives? Should they focus on both price stability and financial stability? Or just concentrate on price stability and leave financial stability to others?

These are the questions I will discuss in my lecture today. In doing so, I will focus on the role of the European Central Bank. And to be clear from the start: the ECB has a price stability-mandate. Still, both branches of the ECB have a role to play in financial stability –monetary policy as well as banking supervision.

I will break down my speech into three parts.

In the first part, I will put on my central banker's hat. As a central bank, the ECB works towards price stability. However, the ECB has also been dealing with issues of financial stability since it was created, working to identify and assess risks to financial stability. And it will continue to do so. Since 2014, the ECB also has the power to take macroprudential policy measures enabling it to top-up national tools aimed at addressing specific stability risks. So, it can go from analysis to policy.

I will next look deeper into macroprudential policy. Can it help to maintain financial stability? And what roles do the ECB, national central banks and other institutions play?

In the third part of this lecture, I will then put on my supervisor's hat. As a banking supervisor, the ECB helps to make banks safer, sounder and more resilient. But as I have said elsewhere, financial stability is more than the sum of its parts.[6] Even if all banks were stable, the financial system could still be a bit shaky. Microprudential supervision can only be part of the answer.

But it is still important. So I will conclude by focusing on how banking supervisors should contribute to financial stability. What tools are needed, what prerequisites have to be in place?

A central banking perspective

As I already said, the ECB's mandate is quite clear. Article 127 of the Treaty on the Functioning of the European Union leaves not a trace of doubt.

It clearly states that the "primary objective of the European System of Central Banks shall be to maintain price stability". But it also says that the "European System of Central Banks shall contribute to the smooth conduct of policies pursued by the competent authorities relating to […] the stability of the financial system."

Further, the ECB needs to identify and assess risks to financial stability in order to comply with its advisory tasks on legislation, in accordance with Articles 4 and 25.1 of the Statute of the ESCB.

Hence, the ECB cannot and should not turn a blind eye to risks to financial stability. The Treaty clearly outlines a contributory role for the ECB in maintaining financial stability. After all, financial stability and price stability are functionally connected.[7] They are linked in good times – and they are linked in bad times. As we saw during the last crisis, financial instability can block the channels through which monetary policy influences prices. Thus, it can limit the ability of central banks to do their job. Without financial stability, it becomes quite hard to ensure price stability.

Edward George, who was at the helm of the Bank of England during crises such as Black Wednesday and the collapse of Barings Bank[8] made this point graphically when he said: "it is inconceivable that the monetary authorities could quietly pursue their stability-oriented monetary policy objectives if the financial system through which policy is carried on (…) were collapsing around their ears".[9]

And in its own monetary policy strategy, the ECB recognizes how important financial stability is for price stability - within the mandate it has been given. In order to best pursue its price stability mandate, the ECB adopts a two-pillar approach to assess risks to price stability. The two-pillar approach, with economic analysis and monetary analysis, includes assessments of financial market developments.

So, financial stability, or rather the lack of it, can affect monetary policy. But it is not a one-way street. We should also be aware that monetary policy can affect financial stability.

Let us take a quick look at the potential side-effects of monetary policy. In the aftermath of the crisis, the ECB has pursued an extraordinarily accommodative monetary policy and deployed a number of unconventional tools. It began, for instance, to buy bonds on a large scale. These tools had the desired effects on the real economy, and thus on prices. They have brought benefits. But we must remain vigilant about their potential costs, too.

For one, the tools may have changed the incentives of banks, businesses and even governments. In fact, low interest rates and abundant liquidity may encourage investors to take excessive risks. Among other things, we keep a close eye on how much risk banks take.

Another issue is that bond purchases by the central bank can reduce liquidity in the relevant markets or distort prices. The more bonds we buy, and the longer we go on buying, the greater the risk that prices will be distorted.

That is why we took steps to limit some of the side-effects of the ECB's bond purchases. Furthermore, our actions had to be guided by careful monitoring of the markets that were likely to be most affected. The ECB takes this duty to carefully monitor markets seriously. And it will continue to do so.

Does this mean that no financial stability issues will follow from the extraordinary accommodative monetary policy? Well, despite all the monitoring and the careful design of the asset purchase programme, there are still issues to consider. Interest rates have been low for a long time now, and liquidity has been abundant.

Prices of several asset classes are influenced by the central bank's policies. So there are some risks. There are risks that bubbles might be building up, and there are risks that assets might be mispriced. Market participants might become too lenient when assessing the real value of assets; and they might overly rely on readily available liquidity and become too lazy to prepare for different, less convenient times.

So, this is a case where monetary policy might affect financial stability. But more often than not, it is the other way round. Mostly, it is the stability of the financial system which affects the tools and the effectiveness of monetary policy. That's why the ECB has kept a close eye on risks to financial stability since long before the crisis.

But how does that work in practice? How do we define financial stability in the first place? And how do we monitor relevant risks?

When it comes to definitions, financial stability is akin to the famous giraffe. It's hard to describe, but you know it when you see it. Or rather: you know it when you no longer see it. Our experts think of financial stability as a condition in which the financial system, including financial intermediaries, markets and market infrastructures, is capable of withstanding shocks and the unravelling of financial imbalances. Only a resilient financial system is able to support the real economy during a potential shock.

The definition of financial stability is quite broad, I have to admit. But I think we need to take a broad perspective when we assess risks to financial stability.

The first step is to routinely look at incoming data from all relevant sectors. We look at both macro developments and micro developments, and we look at both the bank and non-bank sectors. While we focus on the euro area, we are aware that problems can easily spread across borders and so keep an eye on global developments too.

The second step is to analyse the data by applying a wide range of tools. Among other things, we analyse asset prices, and we use early-warning and financial cycle models as well as models to predict outcomes such as changes in banks' profitability.

The third step is to collect market intelligence. After all, it is hard to understand the markets without talking to those who shape them. We regularly talk to analysts, managers and strategists in different financial institutions. We try to find out what they see as potential risks, or what changes they see on the horizon.

And of course, in all this we use expert judgment. We gather data and information and use sophisticated models. But data and models need to be interpreted and assessed. This is where the experience and the knowledge of our experts come into play.

Once we have identified the key risks, we communicate our findings to the public. And we do this twice a year through our Financial Stability Review.

Although the latest edition of the report finds the situation to be quite favourable overall, there are risks which might spoil the good mood at some point. Altogether, we identified four key risks.

The first risk is that market sentiment might suddenly change. This in turn could force prices in asset markets to adjust and set off a downturn in the real economy. Such a repricing could be triggered by many things, both from inside the euro area and from outside.

The second risk has to do with banks. The cyclical outlook for euro area banks is improving, but there are still structural challenges. If financial or economic conditions deteriorate before the structural challenges are addressed, banks may lose their ability to finance the economy.

The third risk is that public and private debt may not be sustainable. Households, firms and governments are highly indebted in a number of countries, with euro area firms, in particular, carrying high levels of debt. And also the sustainability of government debt is a concern.

The fourth risk is about liquidity in the non-bank sector. This sector has been growing for some time now, and no end is in sight. Not only are non-banks highly interconnected with the banking sector, they are also becoming more and more interconnected among themselves: their portfolios tend to be similar, making them more vulnerable.[10]

So, the ECB communicates the risks it sees, and it is always a challenge to do so. We know that the words of a central bank can be powerful. They can affect markets in either direction. Such communication is a challenge we cannot shy away from as it can encourage market participants to behave more prudently. And it might also improve market discipline: by sharing our views on relevant risks, we create greater transparency about vulnerabilities in the financial sector.

What I would like to make clear, though, before closing this chapter is that, while the ECB can contribute to the stability of the financial system, it cannot by itself ensure financial stability. Its mandate determines what it can and cannot do. For instance, the ECB cannot provide liquidity to insolvent credit institutions; and it must comply with the monetary financing prohibition. It is therefore important that all relevant actors are fully aware of their respective responsibilities for financial stability and act in a manner to live up to those responsibilities.

The macroprudential perspective

What the ECB can do however is more than just identify, assess and communicate risks. As I said before, the ECB was given some relevant competences after the crisis.

These competences cover both the macroprudential and the microprudential level. In other words, they cover both individual banks and the banking system.

Let's start with the system-wide approach and macroprudential policy. This policy area is still very young. It was born out of the financial crisis, but it has grown rapidly since then. Here in Europe, we now have a common framework for macroprudential policy.

Macroprudential policy has two goals, broadly speaking. First, it aims to make the system more resilient to shocks. And second it aims to dampen the financial cycle, the booms and busts.

What role does the central bank play in all this? Well, the ECB can only address its macroprudential measures at banks and it's not alone on the stage. The ECB works together with many others – with other European and national authorities.

At the European level, the ECB has a strong ally in the European Systemic Risk Board, or ESRB for short. The ESRB takes a broad view of the financial system. It keeps an eye on banks, insurers, asset managers, shadow banks, financial market infrastructures and other financial institutions. It assesses systemic risk in all these areas of the financial system. And where appropriate, it issues warnings and recommends action. Other European authorities, such as the European Banking Authority, European Securities and Markets Authority, and European Insurance and Occupational Pensions Authority, also contribute to the ESBR's work.

National authorities play a crucial role in macroprudential policy. Under the EU's legislative concept, macroprudential policy is also a national policy. The European perspective complements the national one. And this makes sense, given that financial cycles vary across countries and across sectors. At any point in time, each country or sector might be in a different stage of the cycle and thus face different risks.

Research shows that in a monetary union, macroprudential policy can play a very important role. Unlike monetary policy, it can target specific sectors or countries. This in turn allows monetary policy to focus on price stability. In other words: macroprudential policy can "unburden" monetary policy.[11]

So how does it work in practice? National authorities can choose to take macroprudential measures. The ECB then has the power to top-up some of these measures. And while national authorities are the key players, it also makes sense to involve the ECB. This helps to keep an eye on any cross-border spill-overs and to alleviate any inaction bias that may still exist at national level.

A good example of the important role that the ECB plays in macroprudential policies is the methodology it has developed for minimum additional capital to be held by regional systemic relevant banks. The methodology has reduced heterogeneity in the buffer calibration across the euro area. The current review of this methodology aims to create a level playing field, taking into account national specificities when justified.

All in all, much has been achieved since the crisis. Individual structural buffers have been applied to altogether 116 banks. Six countries have activated the full capital conservation buffer and one country has activated the counter-cyclical capital buffer.[12] Overview of macroprudential policy measures that were being applied in the euro area as of 1 August 2018. But the macroprudential framework is still young, and we can do more to improve it.

We could, for instance, design a single macroprudential toolkit. To do so, we would need to consolidate all the tools and procedures which are scattered in different places within and across different rulebooks.

We should also improve the rules on how authorities should choose and activate the tools they would like to use. There may be ways to simplify and speed up the current multi-step process.

And that's not all. The national authority is not free to use any tool it wishes at whatever time. Rather there is a pre-defined and mandatory sequence of tools – a "pecking order". Wouldn't it be more sensible for the national authority to have the power to simply choose the tool that it deems most appropriate for the risk at hand?

And finally, we need to make the EU framework more comprehensive. We should add some tools, particularly borrower-based ones, such as loan-to-value ratios which come in handy in the upturn of the cycle. Research has shown that such tools can help fight bubbles in real estate markets and limit household leverage.[13]

From a more general point of view, a flexible macroprudential framework is needed; one that allows to quickly respond to market developments. This will be all the more important in the future as macroprudential authorities should be ready to tackle new risks that may arise from the shift towards market-based finance. Key to this will be looking beyond the banking sector; keeping an eye on banks is no longer enough. Many non-banks are now operating in the financial system, and they too can pose a risk to financial stability.

Next to the banking sector is the shadow banking sector, defined by the ESRB as the sector comprising all assets which are not held by banks, insurance companies or central counter parties. And it is big. In terms of assets, it accounts for 40% of the EU financial system. I guess we can all agree that it would be irresponsible not to monitor such a large part of our financial system.

The ESRB's Shadow Banking Monitor was created to do just that. In the recently published third issue of the monitor, the ESRB identified several key risks.

First, some investment funds might continue to face liquidity risks and risks associated with leverage.

Second, the structure of the shadow banking sector itself can be a risk. As I said, it is not just big, it is also closely interconnected with the banking sector. Banks provide funding to shadow banks and vice versa. So there is considerable mutual exposure.

And these links are growing. In 2017, wholesale funding to euro area banks from entities in the shadow banking sector reached the staggering amount of €2.2 trillion.

But apart from that, our picture of the shadow banking sector is not yet very clear. In the EU, almost half of all assets in the shadow banking sector are held by institutions for which we lack a detailed statistical breakdown.

Such data gaps are a cause of concern to economists in particular, but they should raise concerns among all policymakers. We need more data to bring this sector out of the shadows. We need more data to examine and understand it more thoroughly. Otherwise, we might overlook risks that could threaten the financial system.

A banking supervisor's perspective

But let's now turn away from shadow banks and towards regular banks. As I just said, maintaining financial stability is about two things. First, it is about preventing the build-up of bubbles; second, it is about making the system more resilient. Supervising individual banks helps boost resilience.

Indeed, for a long time, microprudential supervision was the only policy field with a specific financial stability goal. But this has changed a lot. So, let's take a closer look at how banking supervision today helps to ensure financial stability.

ECB Banking Supervision directly supervises the 118 biggest banking groups in the euro area – with over €20 trillion euros in total assets. Clearly, these banks – some in their own right, some as part of a group – are systemically relevant. Given their huge role in financing the euro area economy, their resilience is key to financial stability.

The first step is for the supervisor to obtain a holistic view of each of these banks, not only assessing capital and liquidity risks, but also their internal controls and governance. And then the supervisor needs to act and push for improvements in all these elements if needed.

But it is not enough to look at each bank in isolation. To identify and understand new risks and vulnerabilities, the second step is to take a broader view.

As supervisors we have to stay closely attuned to the macroeconomic environment in which banks operate. On the one hand, we take into account macroeconomic assessments drawn up by other European authorities and national supervisors. On the other hand, we also take into account how each bank performs compared to its peers. And thanks to our European perspective, we can compare banks across the entire euro area.

This broad view is indeed one of the great advantages of European banking supervision. Among other things, we have benefitted from it when looking at non-performing loans, interest rates risk in the banking book, leverage finance and business models in general. All this shapes our thinking and helps us to focus on the risks that count.

European banking supervision has helped to maintain financial stability. It has done so by making banks safer and sounder. Euro area banks now hold more capital than ever before: their fully loaded CET1 ratio has increased by about 2.5 percentage points since 2014. Back then, it stood at 11.2%, now it stands at 13.8%.[14] There is no doubt that banks are more resilient today than they were in the past; they are better able to withstand financial shocks and economic downturns.

But, of course, capital is not the full story. Liquidity is also key, as a liquidity crisis in one bank can turn into a risk to the entire system. Banks must therefore manage relevant risks very carefully. And we are not satisfied with each and every bank's self-assessments of its liquidity risk management. Not all banks meet our expectations. That is why we will look closer at liquidity issues through a dedicated stress test in 2019. By improving each bank's liquidity management, we make sure that the system is safer.

The key ingredients of good supervision

So far, I have mostly talked about how things are. Let me now focus on a few key ingredients that I believe are central to a supervisor's contribution to financial stability.

First, supervisors need to be independent. They must be able to take their own decisions. They must be free from pressure from banks or other stakeholders – and they must be free from political trends. But independence is not the same as omnipotence. Independent institutions need to be accountable. The ECB as a banking supervisor is no exception.

But independence goes beyond the institutional setting. It also encompasses the independence of mind. We supervisors must avoid group think and national bias. We should take into account as many views as possible when assessing risks and taking decisions. Looking ahead, I would encourage even more exchanges between the national supervisors and the ECB. This could mean more secondments of staff to the ECB or more cross-border on-site inspections with ECB and national authorities' staff.

Second, for a resilient banking system the regulatory framework needs to be strong. Supervisors can only identify risks in banks, and act to mitigate them, if the legislator gives them the competence to do so.

Supervisors need the right tools and powers. For example, they need the power to request data and information from banks whenever they need to. In making such a request, they should, however, be mindful of the reporting burden on banks. They need to strike a balance and weigh up the burden on banks against the risks that may arise. Last but not least, harmonised rules are essential tools for European supervisors. If we are to ensure equal treatment for all banks within the banking union, we must be able to apply the same rules.

And to do their jobs well, even the most competent supervisors need appropriate budgets. This is at times forgotten, but it is crucial. And I would like to add that money spent on good supervision is money well spent. The budget of European banking supervision pales in comparison to the costs of a fully-fledged banking crisis.

Conclusion

I am deeply invested in all the topics I have talked about today, so I could go on speaking about them for hours. But let me conclude.

I hope to leave you with a simple message. Central banking is a complex business. The ECB's objective of price stability is clear. But delivering on our mandate requires us to deal with a constantly evolving world, and I would be remiss if I told you it's a simple task. Our new competences for macroprudential and microprudential policy have made it even more complex. But I believe we have shown the ECB is up for the challenge.

It is telling that although scholars have tried to define what central banks are, and what they should do, for such a long time, we are still debating these questions today.

And indeed, the answer is not clear-cut. History has shown that price stability and financial stability are deeply connected. You can't have one without the other. So to deliver on our mandate of price stability, we cannot turn a blind eye to financial stability.

As regards monetary policy, we will work to maintain price stability. As regards financial stability, we will continue to cooperate with European and national institutions to work towards a stable financial system. And as regards banking supervision, we will work to make banks safer and sounder.

I wish I could tell you it is always easy to neatly separate these worlds. It is not. But I am confident that all the bright, competent, and committed Europeans working for EU and national institutions can make it happen.

Thank you for your attention.

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1 Ugolini, S., The Evolution of Central Banking: Theory and History, Palgrave Macmillan, London, 2017.

2 Padoa-Schioppa, T., Central Banks and Financial Stability: Exploring a land in between, Second ECB Central Banking Conference Policy Panel Introductory Paper, 2002.

3 Goodhart, C., *The Evolution of Central Bank*s, MIT Press, Cambridge, MA and London, 1988.

4 Giannini, C., *The Age of Central Banks*, Edward Elgar Publishing, Cheltenham, 2011.

5 Ugolini (2017).

6 See speech by Sabine Lautenschläger from 15 February 2018: A stable financial system – more than the sum of its parts, 15 February 2018.

7 See for example Psaroudakis, G., The scope for financial stability considerations in the fulfilment of the mandate of the ECB/Eurosystem, Journal of Financial Regulation, Vol. 4, Issue 1, March 2018; Speech by Mario Draghi, The interaction between monetary policy and financial stability in the euro area, 24 May 2017.

[8] He was deputy governor during Black Wednesday, and later served as Governor later on from or ten years (1993 to –2003).

[9] Quote as reported in Psaroudakis (2018)

[10] Financial Stability Review, European Central Bank, May 2018.

[11] See for example Brzoza-Brzezina, M. , Kolasa, M., Makarski, K., *Macroprudential policy and imbalances in the euro area, Journal of International Money and Finance*, Vol. 41, Issue C, 2015 and Quint, D. and Rabanal, P., *Monetary and Macroprudential Policy in an Estimated DSGE Model of the Euro Area*, IMF Working Paper, October 2013.

[12] Overview of macroprudential policy measures that were being applied in the euro area as of 1 August 2018.

[13] See for example amongst others: Igan, D. and Kang, H., Do Loan-to-Value and Debt-to-Income Limits Work? Evidence from Korea, IMF Working paper, December 2011

[14] Source: COREP, ECB staff calculations using a constant sample of 95 significant institutions which have reported RWA, Capital and Total assets for all time periods.