Luis de Guindos: The European Central Bank and financial stability

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the joint National Bank of Belgium / Toulouse School of Economics / Solvay Brussels School of Economics and Management / European Central Bank colloquium, Brussels, 5 November 2018.

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It is a pleasure to be here today and to take part in this joint initiative of four institutions – the European Central Bank, the Solvay Brussels School of Economics and Management, the Toulouse School of Economics and the National Bank of Belgium – devoted to the topic of managing financial crises. The extensive programme over the next two days will enable policy makers and academics to engage in a frank exchange of views about policy responses to financial crises and a thorough reflection on crisis management from different angles.

The global financial crisis erupted more than ten years ago and triggered a lengthy process of transformation for central banks and supervisory authorities. The G20 summits in 2009 set in motion the global efforts to strengthen our institutional framework by creating more effective oversight of key financial players, products, and markets.[1]

In Europe, we have seen the establishment of the European Systemic Risk Board in 2010 with the power to issue warnings and recommendations, the Single Supervisory Mechanism in 2014 and the Single Resolution Mechanism in 2015, with formal supervisory and resolution competences at the European level.[2]

The sheer number of institutions involved in financial stability raises the question of governance. As a central banker, I would like to address the question of what role central banks play in safeguarding financial stability.

This conference addresses the question from the specific perspective of crisis management. I would like to take a step back and cover the broader institutional set-up and in particular the role of central banks. I will focus on the interplay between monetary policy, banking supervision and macroprudential policy, and elaborate on how central banks fit into this trilogy of public policy responsibilities.

I will first discuss how the responsibility for financial stability is shared among many authorities and the prominent role played by central banks. I will then address the very specific relevance of financial stability for central banks and the toolkit to safeguard it. I will look at the set-up within the Economic and Monetary Union and how recent changes in the European institutional set-up can further enhance financial stability. Finally, I will say a few words about a very topical issue related to financial system resilience: the results of the 2018 EU-wide stress test of the banking sector just published by the European Banking Authority.

Financial stability – a responsibility shared among many institutions

Today's financial system builds on the interactions between many specialised financial institutions. While banks remain at the heart of financial intermediation, insurance companies, pension funds and asset management companies, including investment and hedge funds, play an increasingly important role. All these financial intermediaries face and manage risks, resulting in a financial system which faces systemic risk from multiple sources.

To account for these multiple dimensions, the ECB relates financial stability to the stability of core functions provided by the financial system and, ultimately, to economic growth.[3] Supporting and ensuring the provision of these core functions is the role of public policy. The multi-faceted nature of systemic risk requires the involvement of multiple policy areas to ensure financial stability across the entire system.

The responsibility for safeguarding financial stability is held by three inter-related policy areas.

- First, microprudential supervision is tasked with ensuring the stability of individual financial institutions.
- Second, macroprudential policy is responsible for ensuring the stability of the banking and financial system as a whole, across individual institutions and over time.
- Third, in times of crisis, monetary policy provides liquidity to the financial system as lender of last resort. In normal times, price stability helps to promote financial stability.

The reason why three policy areas are now involved in financial stability is clear. The great financial crisis taught us that microprudential supervision alone cannot safeguard the stability of the banking system as a whole. It focuses on the stability of individual institutions and does not sufficiently account for the systemic aspect of financial stability created by amplification and contagion mechanisms. For its part, monetary policy cannot sufficiently contain the costs of a financial crisis once it erupts.[4] Indeed, crisis management instruments may have averted worse outcomes, but the effective lower bound on interest rates stood in the way of efforts to promptly restore macroeconomic stability through monetary policy.

To pre-empt such situations, academics and commentators have often invoked the need for monetary policy to lean against financial imbalances, but this would imply a deviation from its price stability mandate, at least in the short-run.[5] Monetary policy is able to “get into all the cracks” of the financial system. But it is too blunt a tool to address specific risks and imbalances and would be likely to generate large macroeconomic costs if it tried, as many have argued.[6] In a nutshell, the “leaning” versus “cleaning” debate has, in my view, focused too narrowly on monetary policy alone.

Instead, additional pre-emptive policies need to be called upon.[7] Macroprudential policy is forward-looking and pre-emptive with a clear focus on financial stability. Its objective is to prevent and mitigate systemic risk by strengthening the resilience of the financial system and by smoothing the financial cycle.[8]

The question is then how can the institutional architecture be set up to ensure financial stability by building on the respective responsibilities of supervisory, macroprudential and monetary policy.

Financial stability and the role of central banks

Central banks have always had a keen interest in financial stability, irrespectively of any specific statutory financial stability mandate. Historically, one reason for setting up a central bank was to reduce bank panics through the lender of last resort function.[9]

In today’s world, a central banker’s interest in financial stability goes far beyond the mere lender-of-last-resort function. Indeed, financial stability is a pre-condition for monetary policy to achieve its price stability objective. Monetary policy impulses cannot transmit to the real economy without a stable and well-functioning banking system.

At the heart of the complementarity between price and financial stability is the shared responsibility of central banks and commercial banks for money creation.[10] Central banks have the monopoly for creating outside (high-powered) money, whereas commercial banks provide inside money to facilitate transactions and to finance the broader economy.

The shared responsibility between central banks and commercial banks in this process implies that the value of money relies not just on the provision of outside money by central banks but also on the overall creditworthiness of commercial banks. A stable financial environment ensures that money created by commercial banks remains fully fungible with central bank money across all

parts of the financial system.[11]

A stable banking system is a precondition for any central bank to achieve its main mandate of safeguarding the stability of its currency. It is thus only natural that a central bank holds financial stability responsibilities in addition to those it has for monetary stability.

Traditionally, the two central bank instruments that interact with financial stability have been the monetary policy rate and crisis management instruments. As I already mentioned, the monetary policy rate is in most cases too blunt a tool to address the build-up of financial imbalances.

Emergency liquidity assistance, on the other hand, is a crucial tool for central banks in times of crisis, enabling them to ensure that payment and settlement systems remain operational.[12] Deploying it effectively requires detailed information on market conditions and market infrastructures, as well as supervisory information on individual financial institutions, which should ideally be promptly available to the central bank in the event of a crisis.

Beyond crisis management, ensuring stable conditions requires stronger regulation and sounder supervisory practices. It also involves pre-emptive macroprudential policies that limit the build-up of imbalances and increase resilience ahead of future stress events. These pre-emptive macroprudential instruments can steer market participants towards maintaining conditions that do not endanger financial stability. [13]

The question that frequently arises is whether banking supervision and macroprudential policy should become explicit responsibilities of central banks.[14] The various frameworks in place around the world cover a wide range of institutional arrangements. But irrespectively of the specific institutional set-up, all arrangements assign a significant role to central banks in safeguarding financial stability.[15]

The reasons for this are straightforward.

First, monetary policy and macroprudential policy can be seen as strategic complements. In addressing risks from financial imbalances particularly resulting from asset price overvaluations, more active macroprudential policy allows monetary policy stance to remain accommodative and support a macroeconomic recovery in line with price stability. This strategic interaction requires cooperation between both sets of policy-makers, which is more efficiently achieved within one institution, while observing the appropriate Chinese walls.

One of the main reservations about allocating banking supervision and macroprudential decision-making to central banks stems from the concern about the interaction and possible trade-offs between the financial stability and the price stability objective.[16] In the case of the ECB, the scope for trade-offs is clearly contained, as the primary objective of the ECB continues to be price stability.[17] And I would argue that there is merit in assigning responsibility for decisions in all three policy areas at the central bank, given that price and financial stability reinforce each other. Most importantly, it ensures that decisions are consistent across policy areas; spillovers from one policy area can be taken into account in an effective manner, while duly observing separation rules governing the policy domains.

Second, central banks have a deep knowledge about the functioning of financial markets. They continuously monitor financial conditions to identify vulnerabilities and threats to financial stability, and their assessment is backed up by broad-based market intelligence and the authority to request relevant data from financial market participants. Central banks are particularly sensitive to macro-financial stabilisation goals in this context and maintain a forward-looking, system-wide perspective which considers macro-financial linkages.

Adding banking supervision and, in particular, macroprudential policy to the central bank’s tasks,

shifts the emphasis more strongly towards preventive policies. Macroprudential policy can address financial stability risks in the specific areas where they arise, be it at the level of a country, a sector or a financial institution. It can also effectively free monetary policy from the temptation to counter financial imbalances when systemic risks increase. This reduces the apparent need for leaning. At the same time, macroprudential policy reduces the likelihood and the severity of downturns should risks materialise.

With these conceptual considerations in mind, let me now examine the specific responsibilities of the ECB, starting with its legal mandate.

The ECB's role in financial stability

The ECB's financial stability mandate is based on Article 127 of the Treaty and comes in addition to its primary objective of price stability. It involves several duties.

First, the Treaty requires the ECB to "contribute to the smooth conduct of policies pursued by competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Article 127(5)). Second, it gives the ECB a consultative and advisory role in the rule-making process (Article 127(4) and Article 25(1) of the Statute of the ESCB). Third, it assigns the ECB the task of promoting the smooth operation of payment systems (Article 127(2)). In addition, since November 2014, the SSM Regulation allocates supervisory powers and a clear role for macroprudential policy to the ECB.

The SSM Regulation reflects the decision to allocate microprudential supervision and macroprudential policy responsibilities to the ECB while building as much as possible on national expertise and structures. This implies that, for countries in the euro area, the Governing Council is the ultimate decision-maker on matters of monetary policy, macroprudential policy and microprudential banking supervision.

This institutional arrangement overcomes the "double separation" of policies along the geographical and functional dimension. [18]

Monetary policy operated at the level of the euro area and banking supervision at the level of Member States. This left a gap requiring close and smooth cooperation and coordination.

The drafters of the Treaty had clearly identified that potential problems might arise from this separation. They therefore explicitly allowed for the powers of the ECB to be amended with a simplified procedure should the interaction between area-wide monetary policy and national supervisory powers need to be strengthened to effectively safeguard financial stability. This simplified procedure is established in Article 127(6) of the Treaty and states that the European Council could confer "specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions". The great financial crisis evidenced the need for a more integrated approach while assigning different instruments to the respective objectives of price and financial stability.

How is the ECB fulfilling its financial stability mandate?

With the launch of European banking supervision in 2014, the ECB became the microprudential supervisor of the euro area and macroprudential policies became the shared responsibility of the national competent authorities and the ECB. National authorities, with their detailed knowledge of the domestic banking system and financial structures, are well placed to assess financial stability risks. This goes hand in hand with the responsibility to address financial imbalances and to counter systemic risks using the available instruments.

The ECB, with its cross-country perspective complements the national authorities' responsibilities and can, if deemed necessary, "instead of the national authorities", apply higher

capital buffer requirements and more stringent measures than those adopted by the national authorities to address systemic or macroprudential risks at the level of credit institutions.[19]

Such macroprudential measures have been applied to more than 100 systemically relevant banks in the form of systemic institution buffers, systemic risk buffers or the countercyclical capital buffer for exposures to entire countries.

The aim of establishing the banking union with a single supervisor is to enable banks in the euro area to operate under the same conditions regardless of their location. This would increase the soundness of individual banks and foster financial integration, with capital and liquidity flowing freely across borders. While huge progress has been achieved, the banking union is unfortunately not yet complete. A European deposit insurance scheme is still missing. Such a risk-sharing arrangement would lead to further risk reduction and support financial stability.

All in all, central banks have demonstrated that they can be effective crisis managers in times of stress, but they have often lacked the toolkit to pre-emptively address financial stability risks while they are building up.

Pre-emptive macroprudential policy is essential in any economy to complement and unburden monetary policy. Its instruments can tame the financial cycle when imbalances build up and can ensure the appropriate level of resilience to absorb losses should risks materialise. This is all the more important in a monetary union, where economic and financial conditions across member countries can differ significantly.

I have argued that an effective institutional setup involves ensuring consistent decisions across the microprudential, macroprudential and monetary policy areas. Reflecting the economic rationale, the ECB has legal responsibilities in all three areas in accordance with the Treaty and the SSM Regulation.

EU-wide stress tests

Before closing, allow me to deviate from financial stability frameworks to look at the related topic of the resilience of the financial system, and to focus on the resilience of the euro area banking system today.

Last Friday the European Banking Authority (EBA) published the results of the 2018 EU-wide stress test. For the 33 euro area significant institutions that took part in the EBA exercise the average final Common Equity Tier 1 capital (core capital) after stress stood at 9.9%, up from 8.8% in the 2016 EBA exercise. In terms of capital depletion, the 2018 stress test resulted in an adverse scenario reduction of average core capital of 3.8 percentage points, up from 3.3 percentage points in 2016.

I would like to highlight two main points underlying these results.

First, the improved strength of euro area banks is due to the strong build-up of capital buffers in recent years: The average capital ratio going into the stress test stood at 13.7%, up from 12.2% in 2016. At the same time, banks’ entered the exercise in better condition than before owing to overall improved economic conditions and their continued efforts to reduce legacy assets.

Second, compared with 2016, the adverse scenario in the 2018 stress test was generally more severe for European economies along several dimensions, such as GDP growth, property prices and equity prices. The adverse scenario focused on the repricing of global risk premia, adverse feedback loops between low growth and weak bank profitability, and private and public debt sustainability concerns. The challenge of the 2018 scenario was that the cut-off point was unusually early, and so the scenario does not account for more recent events, in particular developments in emerging markets and sovereign spreads.

The overall high level of resilience achieved by the euro area banking system should not hide the fact that areas of vulnerability remain. To briefly characterise the summary results, I would group the banks into three broad categories depending on their final core capital ratio in the adverse scenario. Clearly, I am using indicative benchmarks rather than formal thresholds. First, banks with stressed core capital ratios above 11% reflect strong capital positions and comfortable capacity to withstand shocks. There are 9 banks in this group, representing 15% of total assets of the euro area banking sector. In the second category, 12 banks had core capital ratios between 9% and 11%, representing about 45% of total assets. These banks displayed a reasonable degree of resilience overall. However, some of these banks still have work to do to enhance capitalisation and reduce their vulnerability to stress. Finally, banks with core capital ratios in the adverse scenario below 9% display a weaker, though still satisfactory, capital position. These 12 entities, representing almost 40% of total assets of the sector, should increase robustness and enhance capital positions to face challenges ahead and will thus be closely monitored.

In summary, the overall resilience of the banks supervised by the ECB has increased compared with the stress test conducted two years ago. Banks start from a better capital position. Capital depletion in the 2016 and the present exercise stand at similar levels. Risks and vulnerabilities identified across some institutions, business models and constituencies, however, require close monitoring. Furthermore, the analysis of aggregate results and their interaction with the real economy, going beyond supervisory ratios, confirms that macroprudential pre-emptive policy has an important role to play in safeguarding the stability of the whole system.

Thank you for your attention.

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1 See Declaration on Strengthening the Financial System from G20 summit in London (2 April 2009) and "The Leader's Statement" from G20 summit in Pittsburgh (24–25 September 2009).

2 For an overview of the European system of financial supervision see the European Commission's overview on Financial supervision and risk management and the legal framework of the SSM.

3 The ECB defines Financial stability as a state whereby the level of systemic risk is contained. Systemic risk can best be described as the risk that the provision of necessary financial products and services by the financial system will be impaired to a point where economic growth and welfare may be materially affected. See: www.ecb.europa.eu/pub/fsr/html/index.en.html

4 See for example for a theoretical explanation: Korinek, A. and A. Simsek (2016) "Liquidity Trap and Excessive Leverage", American Economic Review 2016, 106(3): 699–738, G. B. Eggertsson and P. Krugman (2012) "Debt, Deleveraging, and the Liquidity Trap: A Fisher-Minsky-Koo Approach", The Quarterly Journal of Economics, Volume 127, Issue 3, 1 August 2012, Pages 1469–1513.

5 See for example Bean, C., M. Paustian, A. Penalver and T. Taylor (2010), "Monetary Policy after the Fall," in Macroeconomic Challenges: The Decade Ahead, Federal Reserve Bank of Kansas City, Issing, O. (2011), "Lessons for Monetary Policy: What Should the Consensus be?", IMF Working Paper WP/11/97, April, White, W.R. (2006), "Is price stability enough?", BIS Working Papers No. 205, April, and White, W.R. (2009), "Should Monetary Policy 'Lean or Clean?'", Federal Reserve Bank of Dallas Working Paper No. 34.

6 See Constâncio, V. (2018) "Financial stability risks and macroprudential policy in the euro area",Speech by Vitor Constâncio, Vice-President of the ECB, at the ECB and Its Watchers XIX Conference, Frankfurt am Main, 14 March 2018 and references therein, and Svensson, L. (2017) "Cost-Benefit Analysis of Leaning Against the Wind," Journal of Monetary Economics 90, 193–213.

7 See Cecchetti et al. (2000); Borio (2012), , Hanson, Kashyap & Stein (2011),

8 See Crockett, A. D. "Marrying the micro- and macro-prudential dimensions of financial stability", Remarks before the Eleventh International Conference of Banking Supervisors, held in Basel, 20–21 September 2000.Borio, C. (2003), "Towards a macroprudential framework for financial supervision and regulation?", BIS Working Papers No. 128. Knight, M. D. "Marrying the micro- and macroprudential dimensions of financial stability: six years on"Address at the 14th International Conference of Banking Supervisors, Mérida, 4-5 October 2006.Fahr, S. and

J. Fell, (2017) “Macroprudential policy – closing the financial stability gap", Journal of Financial Regulation and Compliance, Vol. 25 Issue: 4, pp.334–359.

9 For a historical review of the central bank’s role in financial stability see Goodhart (2008) “The Evolution of Central Banks”, MIT Press, Cambridge, MA and London, 1988 andGoodhart, C. (2011) “The changing role of central banks”. Financial History Review, 18(2), 135–154.

10 See Padoa-Schioppa, T. (2002)“Central banks and financial stability: exploring a land in between” in Gaspar, V., P. Hartman and O. Sleijpen (eds)“The transformation of the European financial system”, Second ECB Central Banking Conference.

11 Beyond the benefits of financial stability for the use of money as medium of exchange, it also supports its function as store of value and makes it more accepted as unit of account.

12 Liquidity can be granted through open market operation to the financial system as a whole as well as to individual monetary and financial institutions through emergency lending assistance, building on Bagehot’s original principle. See Bagehot, W. (1878), “Lombard Street: A Description of the Money Market”. NewYork: Sribner, Armstrong. E.

13 See IMF-FSB-BIS (2016) “Elements of Effective Macroprudential Policies: Lessons from International Experience” www.imf.org/external/np/g20/pdf/2016/083116.pdf

14 See Constâncio, V. (2017) “Macroprudential policy in a changing financial system”, Remarks at the second ECB Macroprudential Policy and Research Conference, Frankfurt am Main, 11 May 2017.Schnabel, I. (2016) “What role for central banks in safeguarding financial stability?” or more specifically on monetary policy and banking supervision see Goodhart, C. and D. Schoenmaker (1995), “Should the Functions of Monetary Policy and Banking Supervision Be Separated?”, Oxford Economic Papers, Vol. 47, No. 4, pp. 539–560.

15 For a survey on financial stability arrangements pre-crisis see Oosterloo, S. and J. de Haan (2004): “Central banks and financial stability: a survey, Journal of Financial Stability” Volume 1, Issue 2, Pages 257–273. The responsibilities of macroprudential responsibilities across EU countries see ESRB Follow-up Report with overall assessment on “ESRB Recommendation on the macro-prudential mandate of national authorities (ESRB/2011/3): www.esrb.europa.eu/pub/pdf/recommendations/2014/ESRB_2014.en.pdf

16 See Smets, F. (2014). “Financial Stability and Monetary Policy: How Closely Interlinked?,” International Journal of Central Banking, International Journal of Central Banking, vol. 10(2), pages 263–300, June.

17 See Draghi, M. (2017) “The interaction between monetary policy and financial stability in the euro area”Keynote speech at the First Conference on Financial Stability organised by the Banco de España and Centro de Estudios Monetarios y Financieros, Madrid, 24 May 2017.

18 See Padoa-Schioppa, T. (1999) “EMU and banking supervision” Lecture at the London School of Economics, Financial Markets Group on 24 February 1999. www.ecb.europa.eu/press/key/date/1999/html/sp990224.en.html

19 See Article 5(2), Council Regulation (EU) No 1024/2013 of 15 October 2013 (SSM Regulation).