ENHANCING THE EU ARRANGEMENTS FOR FINANCIAL STABILITY

Keynote address at the session

"European Financial Supervision, Crisis Management on Financial Markets"

by

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Mesdames et Messieurs les membres du Parlement Européen et des parlements nationaux,

Je me réjouis d'apparaître devant vous aujourd'hui et de pouvoir m'exprimer sur la surveillance prudentielle et la gestion des crises financières. Je commencerai mon intervention par rappeler les principaux aspects du cadre institutionnel de l'Union Européenne pour garantir la stabilité du système financier. Je présenterai ensuite les évolutions récentes dans ce domaine qui doivent être prises en compte lors de l'élaboration des arrangements de stabilité financière. Ausgehend von diesen Überlegungen werde ich über die Hauptelemente sprechen, die meiner Meinung nach für die Verbesserung dieser Regelungen wichtig sind. Schließen werde ich mit einigen Beobachtungen zu den Auswirkungen der Finanzmarktturbulenzen auf den EU-Rahmen zur Sicherung der Finanzstabilität.

1. The EU framework for safeguarding financial stability

Let me start by recalling the main components of any framework for safeguarding financial stability. At the national level, a financial stability framework is based on *three main components*: crisis prevention, crisis management and crisis resolution.

The first component, *crisis prevention*, is ensured by the exercise of supervisory and central banking functions. *Supervisory functions* regard the surveillance of the safety and soundness of individual financial institutions. *Central banking functions* include the financial stability assessment aiming at identifying sources of risks and vulnerabilities and their potential effect on the financial system, as well as the oversight of payment and securities settlement systems.

The second component relates to *crisis management*. It may be defined as the set of tools that public authorities may deploy when and if a disturbance occurs in the financial system. *Supervisors* may, for instance, take measures regarding the management of a financial institution, require additional capital from shareholders, or impose reorganisation measures.

Central banks may take actions aiming at restoring normal liquidity conditions in money markets or at ensuring the smooth operation of market infrastructures.

Finally, the third component, namely *crisis resolution*, relates to the arrangements aiming at an orderly handling of a financial institution facing solvency problems and the protection of the rights of creditors, notably depositors. In this case, *treasuries* have also an important role to play if and when the injection of public money is required.

There is evidently a *close interrelation between these three components of the financial stability framework*. For instance, the effectiveness of crisis management and resolution largely depends on the existence of an efficient supervisory and central banking framework able to identify and react at an early stage to potential threats to financial stability. Conversely, the effectiveness of supervisory action depends also on the existence of appropriate arrangements to support an orderly exit from the market by insolvent institutions. Indeed, the fact that institutions could exit the market if they are affected severely by a crisis provides a powerful incentive for them to optimise risk management and draw up proper business plans. At the EU level, a key element is the cross-border dimension which characterises all three components of the financial stability framework. This dimension calls for a smooth and efficient cross-border interplay within and among the set of authorities involved in crisis prevention, management and resolution. In this respect, as a general observation, I would only say that the existence of the Eurosystem provides an extremely strong and effective decision making in the area of central banking, while the Level 3 Committees are expected to develop their own cooperative network in the field of supervision.

2. Key developments in the European financial system

Against this background, let me point out that the European financial system has experienced fundamental developments in the past years, which have a particular bearing on the EU financial stability arrangements. I would like to highlight three of them.

First, the overall progress in European financial integration. The ECB's analysis, conveyed through our annual report "Financial Integration in Europe" demonstrates that financial integration has advanced significantly since the introduction of the euro at the level of financial markets, market infrastructures and financial institutions. Progress has however differed considerably across market segments. The euro area money market has been strongly integrated since the introduction of the single currency, supported by the integrated market infrastructure for large-value payments. As to the wholesale banking segment, there are clear indications of strong progress in financial integration as well. For example, the share of securities issued in other euro area countries and held by monetary financial institutions has strongly increased in the last ten years. By contrast, retail banking markets have remained fragmented.

Second, the growing prominence of EU banking groups with significant cross-border activities. EU banks with significant cross-border activity hold a sizeable and rising share of total EU banking assets. Although the number of EU banking groups with significant cross-border activities increased only slightly between 2001 and 2005, their consolidated assets grew by 54% and their share in the overall consolidated EU banking assets increased from around 54% to 68%.

Third, the high pace of financial innovation which resulted in the rapid growth of new types of financial instruments for transferring risk and of structured credit markets. In turn, this fostered the activities of non-bank intermediaries, many of which are highly leveraged and, mostly, non-regulated. These developments have facilitated the transfer and redistribution of risks across the financial system, thus increasing its efficiency and potentially its resilience to shocks. At the same time, as recent events have shown, the growing complexity of financial instruments and the opacity of exposures of financial institutions can give rise to increased uncertainty regarding the degree of risk involved, the ultimate bearer of the risk, and the extent of potential losses. As we presently see in periods of turbulence, this complexity and opacity may prompt a further propagation of initial shocks and a more generalised contagion.

3. Enhancing the EU financial stability arrangements

The structural developments in the European financial system, which I have just outlined, entail *challenges* to the EU financial stability framework. In a nutshell, given the increasing interlinkages between markets, market infrastructures and institutions in the EU financial system, potential disturbances have EU-wide effects. Therefore, the EU financial stability framework should be able to detect effectively risks to the stability of the EU financial system as a whole and to handle efficiently any crisis with a cross-border dimension.

As you are well aware, there are a number of *policy initiatives* at the EU level, both pre-dating and following the financial market turbulence, in order to refine and reinforce over the medium-term the ability of existing arrangements to cope with such challenges. These initiatives include the strengthening of the financial crisis management arrangements, in line with the strategic roadmap adopted by the ECOFIN in October last year, and the enhancement of the Lamfalussy framework for regulation and supervision, as agreed by the ECOFIN Council last December. In April we will discuss these policy initiatives in order to assess their adequacy and consider possible further progress.

In this context, I would like to emphasise a few elements which I regard as important in the process of enhancing the EU financial stability arrangements.

<u>First</u>, concerning the *general objectives of this process*, I would argue that, while the primary objective of the EU financial stability framework should evidently be to safeguard effectively financial stability, it should also contribute to removing the remaining obstacles to financial integration. This mainly requires identifying and reducing to a minimum the existing divergences in national laws and also in supervisory requirements and practices, which still hinder the effective functioning of the single financial market. Whereas since the inception of the Lamfalussy framework there has been good progress in regulatory and supervisory convergence in the EU, further measures are necessary on (i) the harmonisation of regulatory requirements at the EU level, also through the elimination of the so-called “gold-plating”, namely

the addition by Member States of unnecessary national layers to EU regulation, and (ii) the consistent implementation of the supervisory requirements, agreed by Level 3 Committees, and the development of streamlined and coherent supervisory processes by national supervisors, with the support of Level 3 Committees.

Second, the improvement of the financial stability arrangements should build on the existing largely national responsibilities for financial stability, thus focusing on reinforcing the EU mechanisms for cross-border co-ordination and co-operation between the responsible authorities. In this respect, the Lamfalussy framework provides the appropriate institutional setting. One of its key advantages is the combination of a decentralised set-up of responsibilities for financial stability with the co-ordination mechanisms provided by the Level 3 Committees. A decentralised approach allows drawing on the advantages of geographical proximity and of the established experience and knowledge of local authorities. However, in order to be effective, this approach requires the significant reinforcement of the role and operating mechanisms of Level 3 Committees so as to achieve the required high level of cross-border convergence, co-operation and information-sharing among national supervisory authorities.

Third, concerning the *crisis prevention leg* of the EU financial stability framework, it is crucial to ensure a smooth interplay between central banks and banking supervisors in order to ensure that potential threats to EU systemic stability are detected at an early stage and dealt with in a prompt and co-ordinated manner. Appropriate sharing of information and assessments between central banks and supervisors is needed to detect and evaluate potential risks to EU systemic stability. To that end, a closer link between the financial stability assessment of central banks and the supervision of major cross-border banking groups undertaken by the colleges of supervisors would be helpful.

It is also important to ensure an effective coordination of policy actions between central banks and supervisory authorities in case a systemic threat is identified.

Against this background, the Eurosystem strongly supports the ECOFIN conclusions adopted in October 2007, whereby the Council invites the Commission to assess possible clarifications in the legal framework for the exchange of information between supervisors and central banks.

Fourth, in order to ensure *effective crisis management and resolution* at the EU level, it is crucial that all responsible authorities maintain a high degree of preparedness to handle the complexity of a cross-border crisis situation, while preserving the necessary flexibility of action. Every crisis situation is unique and the arrangements for crisis management and resolution cannot anticipate the full range of causes, propagation channels and outcomes of financial disturbances. Moreover, setting out ex-ante detailed arrangements on how to deal with and resolve crises can unduly constrain the flexibility of action of supervisors, central banks and also treasuries in a stress situation. Instead, the emphasis should be on enhancing preparedness. This may be achieved, among other things, through stress-testing exercises aiming at verifying the resilience of the financial system under stress conditions and through financial crisis simulation exercises aiming at assessing the effectiveness of existing arrangements. In this respect, the periodic conduct of simulation exercises at the EU level is a positive aspect. Also the Eurosystem devotes particular efforts to this area. It has conducted already two simulations which tested the effectiveness of its own arrangements and plans to conduct others in the future.

Finally, I should emphasise that the EU arrangements should also take into account the *global dimension* of financial stability. I do not need to dwell much on this aspect, since the financial market turbulence provides a vivid reminder of how a disturbance in a particular market segment can propagate across many markets and countries.

This entails that the EU arrangements should also include mechanisms which support the co-operation between authorities from the EU and from third-countries in addressing common concerns.

In this respect central banks can claim a long-standing tradition of effective co-operation on a global basis. This has been illustrated recently by the joint initiatives of various central banks to address tensions in the money market.

4. Conclusions

Let me conclude with the possible lessons from the present significant financial market correction for the EU financial stability arrangements.

Careful reflection is taking place at the European and global level with regard to the identification of the main determinants of the present market correction as well as the policy lessons which will have to be drawn by public authorities with regard to the measures necessary to avoid the recurrence of such major turbulent episodes in the future.

First, although it is too early to draw definitive conclusions in this respect taking into account the fact that the present market correction is particularly complex, multidimensional, and ongoing, it seems to me that we know already a number of areas where it is certain that we will have to engineer significant improvements.

- There will be very important lessons to be drawn by credit institutions in terms of their *risk management systems*. The experience of the turmoil has highlighted that some categories of risks have been underestimated by banks including liquidity risk relating to liquidity commitments to conduits and SIVs, concentration risk in structured products and reputational risk associated with sponsoring special purpose vehicles. The current regulatory framework based on Basel II might need some refinement to take these aspects into account.

- There will also be lessons to be drawn in terms of the *structure of incentives* in all stages of the securitisation process and the 'originate to distribute' model. All the relevant players – including originators of loans, arrangers of securitised products, rating agencies, conduits and SIVs, and final investors – should have the right incentives to undertake a proper assessment and monitoring of risks.

- Regarding the *role of public authorities*, let me mention three aspects. First, it is important to permanently identify the various risks at stake in the global financial system. And from that standpoint I have to say that Central Banks had diagnosed a significant underpricing of risks in a large array of markets and have been public on that. It remains complex and difficult to identify the triggering event of a market correction and the nature and scale of propagation channels. This reinforces the notion that the main objectives of a financial stability framework should be to promote to the maximum possible extent sound risk management practices, to strengthen the resilience and shock absorption capacity of financial institutions and to have efficient crisis management arrangements in place.

Second, the experience of the turmoil emphasises the importance of a smooth and effective interplay in terms of cooperation and information exchange among supervisory authorities and between them and central banks in the detection of threats to the stability of financial system, the assessment of the unfolding of a stress situation and the decision on possible policy action to counter potential negative impacts. I will say that the present experience fully confirms the position taken a long time ago by the Eurosystem according to which a close institutional link between central banks and banking surveillance authorities is extremely important.

Third, I trust that in all circumstances, but even more particularly in demanding times of significant market correction and turbulences, it is the responsibility of the Central Bank to solidly anchor inflation expectations to avoid additional volatility in already highly volatile markets. Also important is for the Central Bank to ensure an orderly functioning of the money markets at the level of interest rates required for anchoring the inflation expectations. It is what the ECB has been doing since the beginning of the turbulences, namely since the beginning of August last year.

I thank you for your attention.