Hearing on the ESRB before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, Chair of the ESRB

Brussels, 31 May 2012

Dear Madam Chair,

Dear Honourable Members,

I am very pleased to appear before this Committee today to present the first annual report on the activities of the European Systemic Risk Board (ESRB) – of which you have all received a copy and which is being published as I speak. In my remarks today, I will refrain from repeating the content of the report and will instead focus on three key areas of the ESRB's work over the past year, which will also keep us busy for the foreseeable future. These are: i) the assessment of systemic risks; ii) the establishment of a sound macro-prudential framework in the EU; and iii) medium-term structural developments in the EU financial system. I will then be at your disposal for questions.

1. Assessment of systemic risks in the EU financial system

It is less than a year since the ESRB cautioned that the risks to the EU financial system had become systemic. After a period of stabilisation on the back of actions by central banks and other institutions earlier this year, more recently there have been renewed bouts of volatility and uncertainty, although not at the same levels reached in November 2011.

Fundamental challenges persist. In my view, these include: i) limiting contagion between Member States across the EU; and ii) promoting a macroeconomic strategy that, together with fiscal consolidation, supports growth and furthers the competiveness adjustments needed to tackle the economic imbalances within the EU.

Addressing these challenges in a decisive and sustainable manner is a prerequisite for the success of measures to ensure a more resilient financial system capable of supplying, on a sustainable basis, the financial services necessary to support economic activity. From a macro-prudential point of view, such measures include: i) implementing credible mechanisms for the recapitalisation and restructuring of banks, where needed; and ii) improving banking supervision and resolution at the European level.

In the past, the ESRB has underlined the need for all national and European authorities to act, and to do so in unison, with speed, ambition and a total commitment to safeguard financial stability. Today, I reiterate this call, while acknowledging the efforts undertaken so far.

Within the broader economic and financial context, the financial system continues to face the challenge of adjustment in order to address imbalances accumulated in the past. For banks, progress has already been made on some fronts, but more is needed. For other financial sectors, it is important that international and EU reforms, designed to improve their resilience, are fully implemented and adhered to – an issue that I will return to later.

The ESRB is concerned with two aspects of banks' adjustment. First, it should be carried out in an orderly way to support economic growth to the full extent necessary, without exacerbating market fragility and the positions of others in the financial system. Second, the degree of adjustment planned by the EU banking sector over the coming years must be sufficient to restore confidence in the strength of banks' balance sheets.

With regard to the first point, official data and surveys from many countries across the EU indicate some overall stabilisation in financial conditions in the early part of this year. However, the recent turbulence highlights the uncertainty surrounding the outlook for these financial conditions, given their link to the soundness of EU banks' balance sheets and, in turn, the direct or indirect connections between those balance sheets and sovereign vulnerabilities.

Concerning the second point, close monitoring and a systemic assessment of the feasibility and nature of the adjustment by banks, as well as within the financial system more broadly, is crucial. In this regard, the ESRB has called upon its partners within the European System of Financial Supervision – supervisory authorities at the national and EU level – to regularly collect detailed, ex ante information from banks and other key players in the system, and report it to the ESRB. The General Board will review the latest developments – and their implications – at its meeting in June.

2. A sound macro-prudential framework for the EU

Let me now turn to the work undertaken to establish a framework capable of addressing the deficiencies of the pre-crisis framework in preventing and mitigating systemic risks in the EU.

While the launch of the ESRB was a first, and necessary, step in this respect, it is vital to develop a sound and comprehensive macro-prudential framework for both the EU as a whole and the individual Member States. As indicated in the Annual Report, this has been one of the ESRB's priorities since its inception.

First, in order to create a solid foundation for pre-emptive action against systemic risks, it is essential to develop macro-prudential mandates and tools. In its recommendation published in January, the ESRB highlighted the need for well-defined macro-prudential mandates for national authorities to act either on their own initiative, or in response to the ESRB's advice. In accordance with the ESRB's duty to follow up on its recommendations, the first reports from the Member States outlining their progress thus far are expected by the end of June under the ESRB's "comply or explain" mechanism.

A key lesson from the past is that financial or systemic stability mandates must be accompanied by the means to act. Macro-prudential authorities will need to be equipped with effective policy tools to respond, in a pre-emptive way, to the complex and ever-changing variety of systemic risks. The ESRB is currently working on identifying the minimum set of tools necessary for conducting macro-prudential policies throughout the EU.

Second, it is crucial to ensure that macro-prudential issues are taken into consideration when developing EU legislation for the financial sector, given the impact that such regulations could have on incentives within the financial system. In this regard, I would like to touch on a number of important pieces of EU legislation that the ESRB has been following: i) a draft directive and regulation on capital requirements for credit institutions (the "CRD/CRR"); ii) the proposal for a regulation on OTC derivatives, central counterparties and trade repositories ("EMIR"); and iii) the part of the proposal for the Omnibus II directive that concerns the regulation of the insurance sector.

With regard to the CRD/CRR, I very much welcome the recent progress made by this Committee, as well as by the EU Council, on advancing the proposals put forth by the Commission less than a year ago. Your work together with the Council provides a promising basis for the establishment of important macro-prudential instruments for addressing systemic risks in the banking sector.

To assist you, and the Council, in your work on the CRD/CRR, the ESRB wrote to you in March outlining a number of macro-prudential principles. I urge you to consider these principles in order to ensure that macro-prudential authorities, at both the EU and national level, are fully equipped with a flexible set of policy tools and sufficient scope to act early and effectively to prevent the build-up of systemic risks in the future. Obviously, discretion to pursue macro-prudential policies requires efficient coordination as a safeguard against potential negative externalities or unintended consequences. The ESRB is ready to play a central role in this respect, and work is under way to establish a general framework for the coordination of national macro-prudential policies by the ESRB, where such policies give rise to material spillovers across borders.

The agreement on EMIR was also an important step forward in implementing lessons from the crisis, and it includes a number of useful elements to safeguard financial stability in the EU. The ESRB has started preparations for performing the tasks assigned to it under EMIR.

From a macro-prudential perspective, however, I should point out that, in the view of the ESRB, EMIR does not address the issues raised by the possible pro-cyclical effects of either easing or tightening of collateral eligibility and of requirements for transactions subject to central counterparty clearing. In accordance with its responsibilities, the ESRB continues to examine whether and how collateral requirements could be applied as a macro-prudential tool at a later stage.

The new regulatory framework for insurance activities is currently being finalised. Some important aspects of this framework – such as those related to the treatment of long-term guarantees – are being discussed over the next few days as part of the “Omnibus II trialogue” discussions, in which this Committee is actively involved. The ESRB is aware that several of the issues at stake are potentially relevant from a macro-prudential point of view. In particular, the new regulatory framework (Solvency II) may amplify the procyclicality of insurers’ balance sheets and, in particular, capital levels. This has been recognised by the legislator, which is designing several policy instruments (including some of a macro-prudential nature) to mitigate procyclicality and other factors. It is crucial that such instruments are designed to deliver a clear and credible objective and that their interaction is duly considered to ensure that the use of these instruments has the intended effect.

3. Structural developments in the EU financial system

Finally, I would like to highlight some medium-term, structural developments that the ESRB is currently looking at, with a view to gaining a better understanding of their implications for systemic risk and to identifying appropriate policy responses for delivering a more resilient financial system.

The ESRB is devoting particular attention to structural aspects of both the traditional banking sector and the shadow banking sector. Before commenting on developments in these sectors, I would like to briefly say a few words on the whole financial system, which is currently undergoing a regulatory reform in all its segments. An important goal of such reforms is to ensure a sustainable supply of financial services from the system to the rest of the economy. In Europe, the financial sector has traditionally been centred around banks. However, some activities may shift to other – maybe less regulated – parts of the system in the years to come, perhaps as a direct consequence of the current crisis or as a result of the overhaul of standards for regulated activities and entities. While such developments can, in principle, be of benefit to the system, they must be monitored closely in order to limit the emergence of new vulnerabilities, for example those stemming from shifts driven by regulatory arbitrage.

Turning to the banking sector, the onset of the financial crisis revealed significant shortcomings in banks' funding structures – part of the necessary adjustment I referred to earlier involves a transition to more sustainable funding structures. However, banks' ability to manage this adjustment is being hampered by conditions in European interbank and unsecured credit markets. As a result, there has been a rise in banks' recourse to secured funding markets and innovative funding instruments.

The ESRB is analysing these shifts in funding behaviour carefully from a macro-prudential perspective, to ensure that unintended consequences or new systemic vulnerabilities associated with such behaviour do not go undetected.

The increased reliance on secured funding raises concerns about the extent to which banks' assets become encumbered. If taken too far, insufficient amounts of unencumbered bank assets in the future could reduce the stability of funding within the system and, in a self-fulfilling manner, reinforce the lack of access to private unsecured markets today.

Furthermore, innovative sources of private funding for banks – such as liquidity swaps between banks and other parts of the financial system – could have implications for the level of interconnectedness in the system, as well as the durability of funding during future downturns or stress periods.

Turning to the shadow banking sector, the instabilities that can arise from a highly interconnected system were exposed by the financial crisis. Shadow banking activities were a major contributor to that interconnectedness, in particular given the interlinkages between the regular banking sector and the complex, and opaque chains of financial intermediation that emerged within the system. They also, directly and indirectly, helped to facilitate the substantial rises in leverage in some economies.

As indicated in the Annual Report, the ESRB has already begun work in this area. This has involved, for example, identifying and assessing potential systemic risks associated with European money market funds, on which a report is soon to be published as an ESRB Occasional Paper. The ESRB is also finalising its reply to the consultation launched by the European Commission through its Green Paper on Shadow Banking , which was published earlier this year.

Looking ahead, from a policy perspective, measures to tackle systemic risks associated with the shadow banking system will need to be tailored to the specific risks stemming from the different activities conducted under the shadow banking umbrella. It is important that horizontal focus be placed on the economic nature of financial activities, i.e. on ensuring that activities carried out within the system, and which involve maturity and liquidity mismatches, leverage and/or incomplete risk transfer, fulfil the appropriate prudential requirements, irrespective of where they are carried out or by whom.

Finally, it will be important to ensure global consistency and therefore the full and consistent transposition in the EU of policy initiatives agreed at the international level, notably those due to be announced by the Financial Stability Board. In this regard, the ESRB stands ready to work together with the relevant international and EU institutions and bodies.

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Let me now conclude by stressing that all the ESRB activities that I have presented here today have been carried out with the full involvement and support of all ESRB member institutions and bodies

– notably the Advisory Scientific Committee and Advisory Technical Committee – and in close cooperation with the three European Supervisory Authorities. For this we are grateful and look forward to a continued fruitful cooperation in the future.

Thank you very much for your attention. I am now at your disposal for questions.