The Current Crisis and Beyond

Remarks by Mario Draghi
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More than a year into the most challenging financial crisis of our times we now face a complex and interlocking combination of rising inflation, declining growth, tightening credit conditions, and widespread liquidity tensions pervading the world financial services industry. Authorities are using a range of tools at their disposal to address these challenges. But this crisis has shown, together with the lack of private sector discipline and weaknesses in the regulatory framework, some novel interrelations that call for action on all these fronts concurrently, and this further complicates our tasks.

And yet, as we develop responses to these challenges, we also need to step back and consider how we have arrived at where we are. At a very general level it is now becoming apparent that the transformation undergone by the financial services industry in the last few years has not been fully appreciated in its implications for monetary and regulatory policy making. As was well said by Adrian and Shin in the paper presented this morning, this has been the first post-securitization crisis. Low interest rates and volatility have boosted the size of both regulated and unregulated financial institutions' balance sheets and their leverage during a long period of time. But of course not all of them were able to withstand a sudden change in financial conditions amplified by the accumulated leverage. Market participants failed to soundly manage, measure and disclose risks, with ignorance, greed or hubris playing their customary roles. But that is where, with the benefit of hindsight, regulators should have stepped in responding to the externalities imposed on the financial system by weak financial institutions, the agency problems that foster excessive risk-taking by financial firms and investors, and the collective action problems in such areas as investment in risk management capacity and infrastructure, in market infrastructures, in the maintenance of market liquidity and, above all, transparency.

Still more broadly, reviewing our experience of the past two or three decades, one is struck by the repeated tendency of the financial system to build up risk and leverage over a series of years, then turn and shed risk rapidly and indiscriminately. While the assets and agents involved and the triggering mechanisms differ from one cycle to the next, the cycles have tended to produce significant deadweight costs and distortions in the real economy, both during the upswing and during the subsequent retrenchment, and this is especially significant the more the financial system is leveraged. While we

cannot and would not want to eliminate the bouts of optimism and pessimism that are part of human nature, we must address some of the pro-cyclical implications of our own policy making.

The conviction of the FSF, called a year ago by the G7 to draft the first report in response to the crisis, is that, due in part to a perverse set of incentives, leverage had reached a level that was both excessive for the risk management capacity of many institutions, and misperceived in its real entity. Therefore, improving the ***incentives*** in the system so that risks are appropriately managed and risk control frameworks keep pace with financial innovation; improving the ***resilience*** of the system to shocks, whatever their source; and introducing frameworks for ***dampening the cyclicality*** of risk-taking, have become the cornerstones of our work plan.

Our aim should be to produce a system more immune to the perverse incentives that we have seen, where leverage is lower, and where the sources of leverage and their associated risks are better identified and addressed. Regulatory and supervisory changes will need to go hand-in-hand with enhanced transparency about risk exposures and valuations throughout the system.

Let me start with actions to improve **incentives**. Under the umbrella of the FSF, and in a collaborative effort of national and international regulatory and supervisory authorities, we urged prompt implementation of Basel II, which will align capital requirements more closely to banks' risks (and I will have more to say about this in a moment). We also recommended strengthening Basel II with respect to capital charges for credit risk in the trading book, for re-securitised assets, and liquidity lines for off-balance-sheet vehicles. We encouraged the Basel Committee to strengthen liquidity management practices and buffers. We have called on financial institutions to align compensation better with long-term, firm-wide profitability, and recommended a range of measures to discipline the practices of credit rating agencies and to reduce regulatory reliance on ratings so that investors engage in proper due diligence rather than relying exclusively on ratings.

We also set out several recommendations to enhance transparency and valuation practices. We outlined "leading practices" for disclosures by financial firms, and urged financial institutions to use these as part of their financial reports starting in mid-year 2008. The International Accounting Standards Board, in response to a proposal by the FSF, has initiated a process to develop improved guidance on the valuation of illiquid instruments and related disclosures. We have also called on accounting standards setters to overhaul standards for asset de-recognition and consolidation of off-balance sheet vehicles. And we recommended that securities market regulators address incentives problems in the securitisation chain and work to expand information for investors on securitisation products and their underlying assets. These

measures should improve the ability of investors and others to track the risks taken by financial institutions, and thereby increase the effectiveness of market discipline.

The progress already achieved testifies to the importance we as financial authorities attach to a stronger framework of regulation. Not only has a consensus been built internationally and cross-sectorally on what is needed, but the process of policy development and implementation is moving forward in coordinated and consistent fashion – and faster than we ever experienced in the past. To illustrate:

- Supervisors proposed in July new capital requirements for credit exposures in banks' and securities firms' trading books and will set out later this year adjustments to capital requirements for "re-securitisations" and short-term liquidity facilities.
- In May, the Basel Committee issued revised guidance on liquidity risk management that materially raises standards for sound liquidity risk management and measurement – including requiring banks to maintain a robust cushion of unencumbered, high quality liquid assets as a safeguard against protracted periods of liquidity stress.
- IOSCO and the SEC has set out fundamental changes to its requirements on credit rating agencies to address the quality of ratings, as well as proposals concerning how ratings are used in regulatory guidelines.
- Regarding transparency, over this summer, the larger banks have been using our recommended disclosures to provide expanded information on their risk exposures and valuations.
- And the IASB is making good progress on new guidance and revised standards for valuations and off-balance sheet entities, which we expect to see in the next few months.

There are many other initiatives underway, alongside complementary efforts in the private sector. We welcome the recommendations, along with accountabilities, that have been set out by the Institute of International Finance (the IIF), the Counterparty Risk Management Policy Group, and the American and European Securitization Forums.

The key challenge for us as authorities will be to remain engaged in seeing these and other reforms through, particularly given the short-term challenges we face. Regulatory changes will need to be phased in over time to avoid adding to the adjustment challenges the system faces now. But there should be no stretching of timetables for enhancing disclosures, including of off-balance sheet positions, as this is essential to repairing market confidence.

Even if we do succeed in rectifying the incentive problems that have tended to generate excesses, our financial system will not be spared risk management failures, shocks and disruptions in the future. This calls for strengthening the

system's **resilience**, in terms of both a better financial infrastructure and stronger shock absorbers in financial institutions.

At the level of the infrastructure, a resilient system is one that is able to withstand the effects of the failure of a large financial institution. By reducing the centrality of any one institution to the system's stability, stronger infrastructure should also contribute to reducing moral hazard. A critical priority in this area is to address weaknesses in the operational infrastructure of over-the-counter derivatives markets, and the work undertaken by the NY Fed to this extent should be commended by all the jurisdictions. It is also imperative that we strengthen national and cross-border crisis resolution frameworks so that we can allow weakened financial institutions, including large ones, to fail without putting the remainder of the system at risk. In addition to national reform efforts in a number of countries, work is underway in the FSF and the Basel Committee to strengthen cross-border cooperation and contingency planning among authorities in responding to crisis.

At the level of individual institutions, improving resilience means ensuring that capital and liquidity buffers are large enough to enable firms to resist external shocks – without mandating buffers at a level that impedes efficiency and encourages regulatory arbitrage. The issue is quite complex, because both the actual and the appropriate size of a buffer shift over time depending on the market and systemic environment. With regard to capital buffers, it is not yet clear how required, desired and actual capital levels will evolve over a full cycle under Basel II, but a framework is now in place for tracking and assessing this.

Regulatory minima are one of several inputs into firms' capital decisions. Banks have made significant efforts to raise new capital to meet anticipated needs relative to regulatory minima as well as to respond to the need to reassure markets. Banks clearly see a benefit to maintaining capital significantly above regulatory minima, and markets (including rating agencies) reward them for healthy capital levels.

One reason, among others, that banks maintain this margin is underlying uncertainty over risk exposures, valuations and earnings prospects. When as at present this uncertainty increases, the margin required by the market also rises. To a degree, this is unavoidable. But to reduce the tendency that market reaction lead banks to raise capital (or reduce exposures) to possibly inefficient levels in a systemic crisis, we need a more robust ex ante framework of transparency about risk exposures, along with provisions, margins and reserves for valuation uncertainty, than we have at present.

The appropriate size for liquidity buffers is even harder to mandate, or to predict, than for capital buffers, given the unpredictable nature of shocks to market and funding liquidity, and the understandable reluctance of monetary

authorities to create perfect certainty about when and how they will provide emergency liquidity. But, as with capital, greater ex ante transparency about banks' liquidity risk management frameworks, cushions and supporting arrangements should help reassure investors and counterparties and reduce the risk of sudden drains on liquidity, as well as the uncertainty that, over the past year, has led to wide and volatile liquidity premia in interbank funding markets.

As we consider how to strengthen buffers, more thought needs to be given to how to promote higher buffers above the regulatory minimum in good times, and more flexibility for the system to make use of these buffers when they are comfortably above regulatory minima. Both the banks themselves and their counterparties should be more confident about the banks' ability to draw on such buffers in bad times. Banks will only be willing to do this if they do not fear they will be punished by the market – which brings us back to the importance of transparency improvements. If banks can credibly assure markets and their regulators that risks to their asset values and earnings prospects are being soundly managed and contained, then they may be able to survive a temporary decline in capital levels, while still above their regulatory minimum, during cyclical downturns.

Authorities will be closely monitoring banking conditions to inform decision on the best timing for introducing tighter capital requirements. We will not unduly burden financial institutions during the adjustment phase, but also not miss the opportunity of the next calm phase in financial markets to strengthen the structure of the financial system. Pacing regulatory changes, but firmly committing to them, will contribute to reducing the potential for cyclicality in the system to be deepened by regulatory capital requirements.

There is no shortage of ideas around for how the capital regime might be modified to dampen potential pro-cyclicality. Some have suggested that a regime that adjusts regulatory minima with the cycle could help reinforce the message that buffers need to be built up in good times and are there to be used when a rainy day arrives. To a degree, this is already possible under the second pillar of Basel II. However, too much divergence in national implementation of pillar 2 would raise issues of transparency and consistency in international regulatory arrangements and should therefore be constrained. To be credible, a discretionary system would need to be limited in its scope, fully transparent, and broadly consistent across countries; *ad hoc,* uncoordinated reductions in required minima could be viewed as forbearance and could give the wrong signal about authorities' judgement as to the overall strength of the system.

It may also be possible to give more attention to the mix of capital instruments supporting banks' risk exposures. There may be scope to enhance the quality of capital during strong economic conditions. A complementary policy aimed

at strengthening buffers could look at mechanisms to automatically increase bank equity levels in bad times, such as reverse convertible debentures proposed by Flannery or the insurance scheme proposed by Kashyap, Rajan and Stein. Although many issues of security design would need to be addressed for these instruments to effectively discipline banks, generate adequate investor demand, and to be reliably collected on when bad states occur, these mechanisms could potentially reduce the bad-signal problems associated both with discretionary changes in minima and with capital-raising efforts by the banks themselves. A necessary complement would be a disclosure framework for risk exposures and valuations that prevents the market taking conversion events or the resort to insurance as a trigger for a broader downgrade of the system's future prospects.

Strengthened capital and liquidity buffers and improved incentives to assess and manage risk should all help reduce the **pro**-**cyclicality** of the financial system, and, in the new configuration of the financial services industry more than ever, help monetary policy to attain its traditional objectives. But should monetary policy itself embody in its objective function the health of the financial system?

As Chairman Bernanke and others have noted, we cannot afford to ignore the health of financial markets when setting monetary policy. It would be difficult to disagree with this statement, and we should try to make it operational considering however that its application may have different degrees of intensity. We should certainly use the monetary and credit aggregates that give the best projections of financial conditions for a given structure of the financial services industry. But how to go beyond that is a matter of considerable complexity. Though I share the importance of the policy goal, it should be clear that how to define the objective function is not only analytically difficult, but it would also pose serious institutional challenges. For a central bank whose primary mandate is to preserve price stability alone, introducing financial stability as an additional objective could introduce a trade-off where none exists today. Indeed, at times of extraordinary volatility and dramatic risk re-pricing, maintaining price stability could be the best contribution that monetary policy could give to the return to financial stability. The same remains true during peaceful times, when prolonged periods of double digit growth in several credit aggregates should call for action to protect future price stability even if in absence of an immediate danger. Second, I can only point at the difficulty of having a framework that is as clear and measurable as the one we have today for our monetary policies. But where I see the greatest difficulty is in the amount of information that would be needed in order to run a monetary policy having financial stability among its objectives. In other words, we would have to know about both the regulated and the unregulated parts of the financial services industry as much as we know about inflation and output. Of course this would also be the area where, were we to move in this

direction, the benefits from enhanced transparency and interactions with regulatory policy would be greatest.

In conclusion, the next few years are likely to be ones of low risk-taking and progressively low leverage, as financial institutions and households repair their balance sheets and as internal and external macroeconomic imbalances are resolved. These adjustments will not be painless, and ensuring that they take place in an orderly manner will pose substantial challenges for policymakers: Preserve price stability while supporting growth, and continue injecting liquidity as needed by an industry that is still far from having resolved its problems, at a time of strong inflationary pressures and tightening credit conditions.

In such a situation, monetary policy cannot be the only, or even the main tool for reflating the economy and the financial system. Fiscal policy will have a key role to play, in its various configurations. But equally important would be to recreate an environment where banks during this current transitional period were both able and willing to use their buffers to lend, and capital markets were able and willing to fulfil their functions. For this to happen, the uncertainties about risk exposures and asset valuations, about developments in the real economy, about the strength of financial, corporate and household balance sheets need to be adequately addressed. This implies a central role for improved transparency as well as action by the private sector to repair balance sheets and strengthen the functioning of markets.