SPEECH

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■ The ESRB – reflections after 9 months of operation

The financial crisis that started in 2007-8 exposed serious weaknesses in the regulatory system. *Firstly,* it turned out that the banks had too little capital and that the quality of that capital was not good enough. Furthermore, issues of liquidity had largely been neglected by regulators. All this has been addressed by the Basel III compromise, which is to be slowly implemented over the years to come - too slowly in the view of some countries, too quickly according to others.

Secondly, the crisis revealed some embarrassing weaknesses in the EU framework for financial stability. The quality of supervision varied substantially between countries and coordination within Europe was insufficient, to say the least. Perhaps even more importantly, the concept of macro-prudential supervision (I will return to this concept in a while) was largely unheard of. To address these issues, the Commission, in late 2008, set up a group (where I had the honour of being a member) led by Jacques de Larosière with the mandate of presenting a roadmap for strengthening the European supervisory framework. The group delivered its report in March 2009. One of the main ideas was the creation of a new institution, which eventually came to be called the European Systemic Risk Board and which is my subject for today.

Thirdly, the crisis made it apparent that the framework for the resolution of failing banks was grossly inadequate. Although steps have been taken to address this question in several countries, a lot of issues remain to be solved, particularly relating to cross-border failures. But this is not for today's discussion.

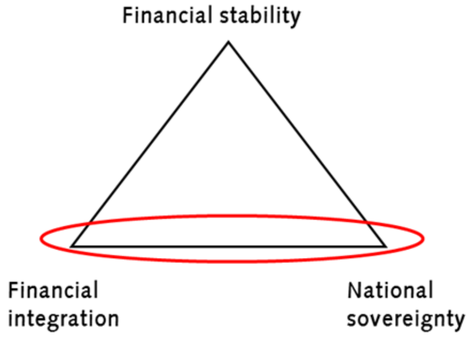
The EU's financial trilemma

The core of the challenge facing the EU is conceptually quite simple. In Europe, we have built a framework based on the logically inconsistent idea of having one single market controlled by 27 sovereign nations. From a financial stability point of view, this is definitely no recipe for success. On the contrary, it is a source of coordination problems and conflicts of interest among the EU countries.

This challenge has been described by Professor Dirk Schoenmaker as the "financial trilemma of Europe". We have three goals – financial stability, integration, and national sovereignty – but only two of these can be reached.

Until the financial crisis, the combination of financial integration and national sovereignty seemed to work well in the EU (Figure 1). Financial crises were not considered to be likely and financial stability came far down on the political agenda. In connection with the financial crisis, however, policy makers have been forced to realise that increased financial stability has to come at the cost of either financial integration or national sovereignty.

Figure 1



In principle, there are two options.

- Firstly, there is the **federal approach**, where you allow for a full delegation of powers to the EU level, including regulation, supervision and crisis management (Figure 2).
- Secondly, you can abandon the idea of the internal market and return to a system with **full national control of domestic financial systems** (Figure 3).

Figure 2

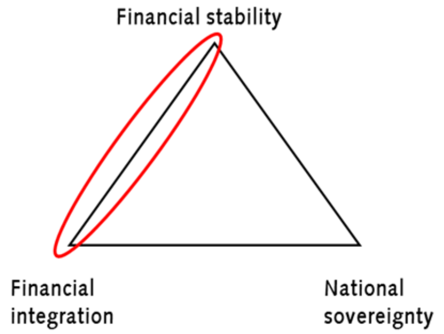
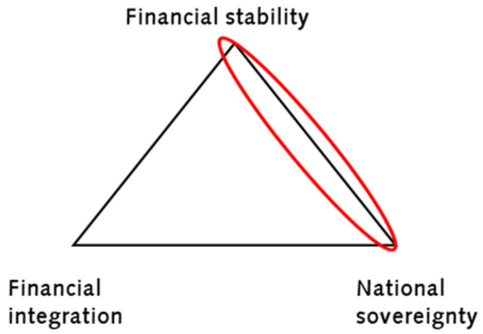
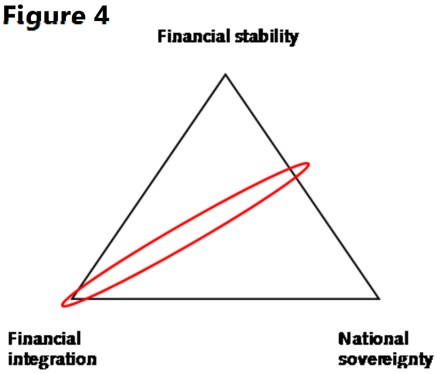


Figure 3



The de Larosière group opted for a third way – the middle way – to reform the EU financial system. In terms of the financial trilemma, this means keeping financial integration and, at the same time, trying to find a reasonable compromise between financial stability and national sovereignty (Figure 4). Somewhat stronger cooperation, but still resting on national sovereignty.

Figure 4

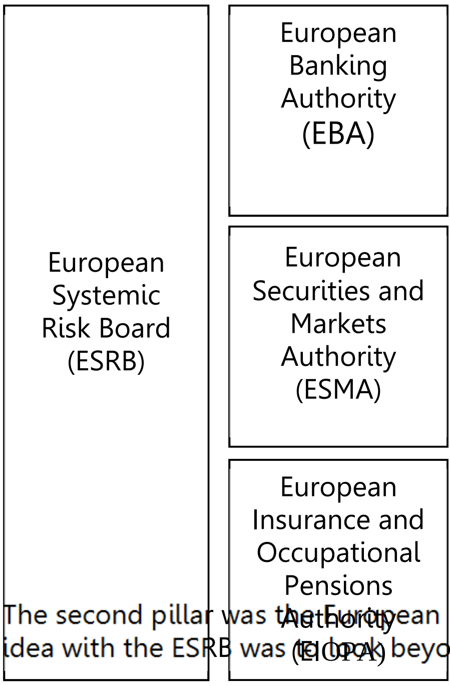


Given the present European crisis, you may well ask whether this is a possible compromise or whether it will be just another damp squib. Only time will tell. But within this concept, there is room to move towards stronger European cooperation.

The EU's new supervisory structure

The de Larosière proposal rested on two major institutional pillars. The first related to the previous "level 3" committees, which were to be strengthened, transformed into authorities, and given as much power as possible without having to change the European Treaty. Out of this came the three European Supervisory Authorities (ESAs), namely the European Banking Authority (EBA) in London, the European Insurance and Occupational Pensions Authority (EIOPA) in Frankfurt and the European Securities and Markets Authority (ESMA) in Paris. We discussed whether these three authorities could be merged into one, but that was considered premature. Suggesting such a merger might have delayed the whole political process (Figure 5). Trying to move the three to the same city was considered equally impossible.

Figure 5 The EU's new supervisory structure

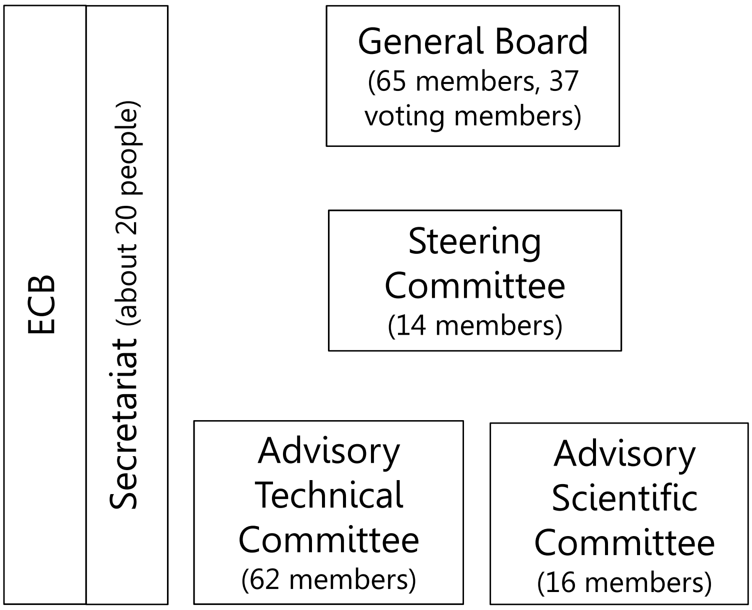


The second pillar was the European Systemic Risk Board, the ESRB. The main idea with the ESRB was to look beyond the supervision of individual institutions and focus on the risks relevant to the financial system as a whole. There was a widespread feeling that supervisors in many countries could not see the wood for the trees – and certainly not any woods in any other countries. So the new body should work with issues systemic to parts or to the whole of Europe. As time has passed, this task has become known as "macro-prudential supervision".

The institutional set-up of the ESRB

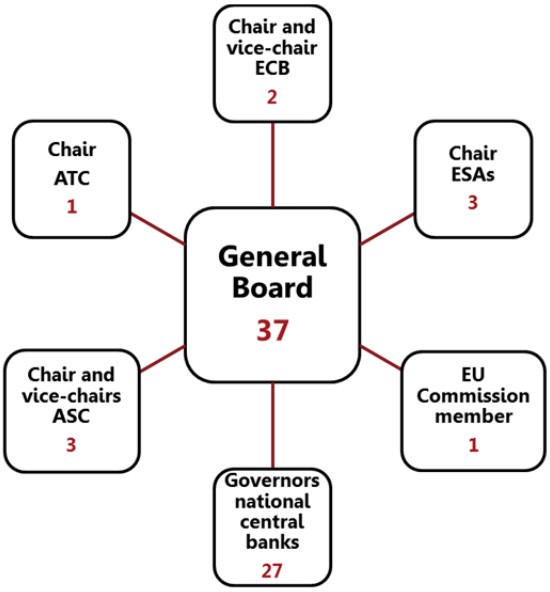
Legally, the ESRB is an independent EU body located in Frankfurt and with a Secretariat provided by the European Central Bank. The President of the ECB is also the Chair of the ESRB. The ESRB has no binding powers. Instead, it can issue warnings and recommendations to national authorities and to EU institutions. These warnings and recommendations can be either public or private. The effectiveness of its recommendations will depend on the attitude of the addressees to the "comply or explain" principle. This principle simply says that either you do as recommended or you explain why you have chosen not to comply. To work, it requires respect for the institution issuing the recommendations.

Figure 6 The structure of the ESRB



The ESRB is unique in that it brings together representatives from central banks and financial supervisory authorities from all 27 Member States, as well as representatives from the three European supervisory authorities and from the European Commission. However, this also makes the General Board a large body consisting of 65 members – 37 voting and 28 non-voting. Decisions are taken by simple majority, but a majority of two thirds is needed to adopt recommendations or to make a warning or recommendation public. The fact that ESRB decide by voting rather than by consensus is important, since blocking minorities can be avoided. The majority of voting rights are held by the national central banks (27 voting rights) while the national financial supervisory authorities have one non-voting representative per Member State in the General Board. This gives the central banks a strong role.

Figure 7 Voting rights of the General Board



Obviously, this requires efficient preparations for meetings. A Steering Committee with 14 members has therefore been established with the purpose of guiding the work to be presented to the General Board. The majority of the Steering Committee members represent the EU institutions and in addition there are four elected members from the national central banks. Two advisory committees have also been set up – the Advisory Technical Committee, chaired by Stefan Ingves of the Riksbank and the Advisory Scientific Committee chaired by Professor Martin Hellwig of the Max Planck Institute. The Advisory Technical Committee (ATC) mirrors the composition of the General Board with 62 members. The Advisory Scientific Committee (ASC) is smaller, consisting of only 15 academics and the chair of the ATC. I have been a member of the ESRB and the ATC at its first meetings

Box 1 Steering Committee Members

- ESRB Chair (ECB President) and first Vice-Chair
- ECB Vice-President
- Governors of 4 Central Banks
- European Commission representative
- Chairpersons of the three ESAs
- President of the EFC
- ATC Chair
- ASC Chair

The ESRB General Board held its inaugural meeting in January and has since met three times. It will meet again in December. The meetings were prepared by the Secretariat, the Steering Committee and the Advisory Technical Committee. The ATC has also been supported by the work of several working and expert groups.

The ESRB's work so far

I hardly need to point out that the ESRB started in a very difficult period when systemic risks in Europe seemed to be greater than ever and when political and economic issues were tightly interconnected. Obviously, the work of the ESRB has largely focused on the immediate challenges of the current situation. But work is also taking place on more long-term structural challenges to the EU financial system.

The vicious financial triangle

At its June meeting, the ESRB concluded that the most serious threat to financial stability in the EU stems from the interplay between the vulnerabilities of public finances in certain EU member states and the banking system, with potential contagion effects across the Union and beyond. At the last meeting on September 21, the ESRB stated that the risk to stability has increased considerably.

I think we can all agree with this conclusion. Over the summer, the weakening prospects for economic growth have further added to the difficulties. We now face a dangerous interplay between fragile public finances, weak banking sectors and low economic activity both at global and EU levels – the vicious financial triangle. It was right of the ESRB to put this issue at the very top of its agenda, in spite of its highly political content. Anything else would have seriously hurt the credibility of the ESRB. It is vital that the politicians now stick to their previous commitments and do whatever else is needed to restore market confidence.

To limit potential adverse spill-overs, the ESRB has also discussed how to improve the resilience of the EU financial system. The ESRB has highlighted the importance of the stress tests performed by the EBA, the European Banking Supervisors – not least as a way to improve the transparency of the financial system. The ESRB has therefore called on the competent authorities in the EU and its Member States to contribute to clear and rigorous assessments of the banks involved. It has also called for national private or public back-stops to be put in place to deal with the potential need for bank capital. Last week, the ESRB sharpened this message asking supervisors to coordinate efforts to strengthen bank capital.

I find the stress-testing to be a very useful exercise. I also believe that the disclosure of relevant data is an important tool for building market confidence, reducing uncertainty and promoting financial stability. However, there is still room for improvement. No doubt the macro-scenario could have been more conservative and possible contagion between banks and countries could have been handled better. The ESRB will have an important role to play in the construction of future stress tests.

Bank funding vulnerabilities

In June, the ESRB also pointed out that bank funding vulnerabilities could pose a threat to financial stability. The ESRB noted at the September meeting the progressive drying-up of bank term funding markets, and that the availability of US dollar funding to EU banks also had decreased significantly.

In Sweden, we have, for some time now, highlighted the risk of Swedish banks' reliance on short-term funding in foreign currency. The Riksbank's stress tests indicate that the Swedish banks have a good capacity to handle bigger loan losses, but that they take somewhat larger liquidity risks than many other European banks.

Lending in foreign currency.

The ESRB has also looked into the risk stemming from lending in foreign currencies to unhedged borrowers. This risk has been highlighted by recent fluctuations of some currencies and the potential impact on unhedged household's capacity to repay loans taken out in foreign currency. In view of this, the ESRB has developed policy proposals targeting credit, liquidity and funding risks, as well as the risk of miss-pricing loans. In Hungary and Austria problems related to foreign exchange lending have become acute due to the appreciation of the Swiss franc.

In Sweden, we have experience from excessive foreign-currency lending, both from excesses in Sweden in the 1990s and, more recently, from the Swedish banks' foreign currency lending in the Baltic States.

Challenges

– to define the concept of macro-prudential supervision

The ESRB is still a new body and it will take some time before it has fully settled in to its work. The concept of macro-prudential supervision is new and is often interpreted very differently by different people, depending on their background. An important task for the ESRB will therefore be to make this concept more precise. What should a macro-prudential mandate look like? How should we define macro-prudential tools? What institutions should use the different tools, and how should these be held responsible for using (or not using) them? These are important questions that are being discussed in many countries, not only in Europe. One important instrument that has been discussed widely in the Basel framework is the countercyclical capital buffer. This instrument has clear cross-border effects and we should, in the ESRB, be able to discuss the principles for setting these buffers.

– *to gain credibility*

As the ESRB does not have any binding powers, it needs to earn credibility if the principle of "comply or explain" is to work in practice. As I see it, this can be done in three ways.

Firstly, the ESRB's risk assessments and recommendations to act upon them need to be of high quality and to be presented in a timely manner.

In doing this, the ESRB should take advantage of its unique composition of representatives from the EU institutions, as well as national central banks and financial supervisory authorities. This institutional set-up gives the ESRB a great opportunity to gather relevant information from all key players in the EU financial system. For this to function in practice it is necessary that all actors are willing to share relevant information so that the ESRB can perform its tasks properly. However, sharing information, although simple in theory, often turns out to be difficult in practice.

Secondly, the risk assessments and recommendations need to be well-understood and accepted.

This will require efficient communication. The issuance of warnings and recommendations is one way to communicate, either in public or in private. So far, there have been press conferences after the General Board's meetings. Under the ESRB regulations, the ESRB is also required to publish an annual report. This report will be presented by the chair of the ESRB to the European Parliament and the Council in an annual hearing.

But there is a clear need to further develop the ESRB communication. This is important, not only to legitimise the work of the ESRB but also to increase public awareness of systemic risk and macro-prudential policy. The ESRB could make a substantial contribution to promoting discussions in this field, both nationally and at the international level.

Thirdly, Member States must be willing to accept warnings and recommendations from the ESRB.

This may perhaps be the most difficult objective to achieve. Accepting warnings and recommendations may be difficult to accept when there is a political cost. It is therefore vital that the ESRB proves its independence and that it can express its views even when politically inconvenient.

The "comply or explain" principle is a powerful tool

In my view, the ESRB has had a better start than might have been expected, given its size and composition. It has focused not only on identifying risks, but also on suggesting how to handle them. And the risks discussed have been the relevant ones, in spite of their political sensitivity. Certainly, a lot remains to be done before the ESRB will have established its working procedures. And it remains to be seen what it will be able to produce under normal conditions, out of the present crisis mode. But, properly managed, it should develop into a useful institution, forcing countries and authorities to act in time to avoid difficult and dangerous situations. Comply or explain is a powerful tool, if respected.