Conference of Finance Committee Chairs

Brussels, 20-21 September 2010

Remarks by Alexandre Lamfalussy

Preliminary remarks

I much appreciate the invitation to address this prestigious conference on where we stand in the crucial field of the evolving financial architecture and the control measures of the financial institutions. This is a flattering invitation, but also a challenging one. Financial institutions, and in particular banks, have been at the heart of the crisis both as major actors and on occasion innocent victims of the crisis. It is also clear that public authorities failed in their crisis prevention responsibility, although once it became clear that we were on the verge of a systemic crisis both the central banks and the governments acted on the whole with commendable speed and determination. But we are not yet out of the woods and it is not easy, in these circumstances, to assess the probabilities of how fast we shall be able to extract ourselves from our current predicament.

This, however, is not the topic I would like to address to-day. I rather propose to ask a deliberately forward looking question: where do we stand with the various reform programs which, if implemented, should be able to protect ourselves in the future against the risk of having to deal with the renewed danger of a systemic crisis?

I think that this is a question of some importance. One reason for this belief is my conviction that our globalised, competitive and highly innovative financial markets, if left to their own devices, would continue to breed financial disturbances of a size and nature that could lead to systemic meltdown. I note with some preoccupation the speed with which new, complex and bizarre innovations appear at the slightest relaxation of financial stress – yet we should have learnt by now the lesson of mistrusting the opacity spread by ingenious innovations. Another reason is that I have some doubts about our ability to deal with those global macroeconomic imbalances which played an instrumental role in the development of the crisis, and therefore are likely to continue to nurture a “crisis-friendly” environment. I refer, of course, to the persistence of large scale savings/investment imbalances and their capacity to create excess liquidity.

In what follows I propose to focus on three broad groups of reforms: (I) Specific reform initiatives, the purpose of which is to correct the identifyed dysfunctions of financial institutions and markets; (II) The reform, at the European level, of the regulatory and supervisory process; and (III) Structural reforms.

Specific reform initiatives

During the spring of 2009 I was happy to observe two favorable developments which warranted a measure of optimism. On the one hand, we were witnessing an emerging professional consensus on a list of dysfunctions which called for repair. On the other, there appeared to be a genuine political will to carry out this repair.

Here are a few examples of the dysfunctions taken from the 23 February 2009 interim report of the High Level Committee which I had the pleasure to chair:

the dysfunctions of the “originate and distribute” banking model;

the nefarious role played in the crisis by the credit default swap (CDS) market;

the dismal failure of the rating agencies;

the breakdown of the risk management models;

the potentially destabilizing role of the remuneration schemes;

and last but surely not least the procylicality of the system.

You can see that this list was very close to that established at the same time by the de Larosière report.

Where are we to-day? Well, the world has changed quite a lot. On the one hand, the working parties put in place both at the European and G20 levels have delivered high-quality reports. The reform proposals have been outlined with a great deal of competence. All this would seem to justify last year's burgeoning optimism. Unfortunately there is a stark contrast between the quality of the work delivered by the experts and the very slow pace of implementing their recommendations. Some of the difficulties were not unexpected: it happens in all negotiations that when you have to agree on specific details – the legendary footnotes – the devil will do everything to slow down the decision making process.

But unfortunately this is only part of the story. I note much more worrisome forces at work behind the scenes. The most important is the radical change of the behavior of financial market participants. Early 2009 they had an open mind and acknowledged the need for reform. Not any longer: an open hostility has arisen against all serious reform initiatives.

A striking example is the intense lobbying by the financial business world against the reform of the CDS market. This is a very serious matter. Almost all independent experts recognize that, in order to reduce systemic risk, CDS contracts between counterparties should be netted. For this reason, there is now general support for the creation of a central clearing counterpart (CCP), since it would considerably reduce counterparty risk, improve transparency and facilitate risk control. The reason for this intense lobbying is quite simple: the replacement of the over-the-counter deals by settlements via a CCP, which implies standardization, would radically reduce the intermediaries' profit margins. And this reduction would be even stronger if the negotiation of the contracts had to be carried out in organized markets.

The second point I have to make relates to the attitude of governments. Their "sense of urgency" which was so vivid a year and a half ago has been replaced by a certain "reform fatigue". This should not come as a surprise, given the burden and complexity of the problems they have had to handle. But we should nourish no illusion: given the determination of the most influential market participants to reject substantial reforms, the work carried out by the experts will bear no results without the explicit and strong support of their political masters. I realize that we are asking quite a lot of our politicians: to support reforms which appear far too technical to be understood by most of their citizens, and carry therefore no electoral reward. It is therefore understandable, but regrettable, that most of our politicians are concentrating their support on reforms which have a populist appeal, such as the limitation and regulation of the income of the members of management or of the traders – an eminently respectable objective (which I very much approve), but the realization of which will have only a modest impact on crisis prevention.

Reforming the European financial regulatory and supervisory architecture

The badly needed reform initiatives of the European regulatory and supervisory architecture received a welcome impetus from the acceptance of the main proposals of the de Larosière report (in short DLR) relating to this subject. The architecture designed by this report is based on two institutional pillars: the European Systemic Risk Board (ESRB) and the European System of Financial Supervision (ESFS). The ESRB will undertake macro-prudential supervision, while the ESFS, composed of three supervisory authorities (for banking, insurance and securities markets) is primarily concerned with micro-prudential and investor protection issues.

I have been on record of expressing my full support of this architecture, and the High Level Committee which I chaired shared my view. I had two personal reasons for feeling happy. As some of you may remember, in one of my earlier incarnations (in 2000/2001) I chaired a Committee of Wise Men on the Regulation of European Securities Markets which came up with a four level regulatory approach. This has by now been accepted for the whole of the European financial industry, and carries my name as a sort of retribution for my sins. This approach represented, I believe, a helpful contribution to the process of financial integration in Europe, but it was becoming obvious that it called for further progress (I refer here to the difficulties encountered at Level 3). The DLR, by proposing the setting up of the second pillar has come at the right time and did what was missing from my initial reform.

My second personal reason was that since the dot.com crisis I have been beginning to worry about the ability of the European authorities to prevent or to handle a major financial crisis. I spelled out my misgivings in October 2004 in my Pierre Werner Lecture in Luxembourg under the title *Central Banks and Financial Stability* where I argued that the European Central Bank should be given an operational co-responsibility in the supervision of the thirty-to-forty major banks in Europe whose problems could have directly systemic consequences. I did not expect much support for my suggestion, and I did not get it. The time was not yet ripe for taking into consideration such an idea. Jacques de la Rosière's European Systemic Risk Board comes as close as politically possible to my 2004 proposal – hence my happiness.

This does not mean that everything will be plain sailing from here. There is little doubt that introducing a macro-prudential supervision component is a major innovation, which has been lacking until now and whose absence constitutes one of the main explanation for the failure to prevent the current crisis. But the operational organization of macro-prudential supervision is not an easy task. A great deal of progress has been achieved by the careful work of the Commission, but there are surely details which have not been tackled. My own main concern is about information gathering and transmission. Effective macro-prudential policy will require that large quantities of confidential data be transmitted to, and processed, by the staff of the ESRB. Previous experience suggests that one should not underestimate the natural reluctance of the data providers to transmit all requested data, and in a prompt fashion

An additional concern is that micro-prudential supervisors, who are supposed to be the main data providers have neither been mandated, nor trained, to select the pieces of information which should trigger macro-prudential interest, and potentially action. Their main job is to check whether specific banks comply with the existing regulations and with their own risk management models. They are not supposed to wonder whether the generalization of securitization or the large scale development of quasi banks entail systemic risk. That is the job of macro-prudential supervisors. It is of course essential that these supervisors have access to micro-prudential information; but this is not enough. Macro-prudential supervisors must have direct and frequent access to "live" bankers at all levels of responsibility both to observe developments in specific banks that could have systemic implications and gather information on what is happening in the broader markets.

This is far from being a new problem. During my “prehistoric” BIS years, when I tried to promote a dialogue between the bank supervisors of the Basel Committee and the central bankers working in the Eurocurrency Standing Committee (this misleading title hid a macro-prudential mandate) we did not get very far. To be precise, during the late 1970s some key central bankers were getting uneasy as they watched the wild enthusiasm with which banks lent to developing countries, notably in Latin America. I met very little concern among the banks supervisors, who insisted on the floating rate arrangements which were supposed to protect the banks’ margins, and on the “highly liquid” nature of the banks’ claims. Fortunately the members of the Eurocurrency Standing Committee had at their disposal global statistics on international bank lending which showed an alarming rate of increase in banks’ claims, held in their portfolios, and which were very short-term indeed. This carried the argument, since it was obvious that the liquidity of these claims was an illusion, and that the protection of the margins in case of rising interest rates would have the perverse effect of pushing the debtor countries towards the unilateral suspension of their debt service –which in fact was beginning to happen in 1982. But in to-days’ securitized world the macro-prudential supervisor do not not possess such simple statistics (where are the “final” lenders?), - hence the need to use far more complex investigative methods which cannot rely exclusively on second-hand information.

Structural reforms

I have come to believe that among the wide range of reform endeavours structural reforms should receive priority treatment. This, of course, is more easily said than done. There are two reasons for this. On the one hand, such reforms have to be implemented globally – and financial structures vary considerably from country to country, and even from one continent to another. Just look at the well known differences between Europe and the United States On the other hand, they touch substantial vested interests, and you can count on the fierce opposition of the beneficiaries of those interests. I am particularly worried by the fact that Europe is just nowhere in this field, as compared with the United States. We run the risk that we shall have to take for granted the US initiatives in this field, which is surely not the best way to protect our interests.

Whatever opinion one may have about the desirability and feasibility of the Volcker package, there is no doubt in my mind that the questions to which the package attempts to supply an answer are the right ones. Has the financial sector grown in size beyond a level that would be justified by providing services to the ”real” economy? If so, what to do? Has the size of individual financial firms (and not just banks) grown to an extent that makes it hard to bail them out, and perhaps even harder to let them fail? If so, what to do? And what are the merit and feasibility of the family of the narrow bank arguments?

But most importantly, *how can we extricate ourselves from the unappealing moral hazard trap?* The widespread belief that the systemically important financial institutions will always be bailed out has two devastating consequences: it encourages reckless risk-taking by such institutions, and provides them with an unfair competitive edge over the rest of their financial industry by ensuring cheaper financial resources for them. To avoid this happening, it has to be made clear that no financial firm, and especially banking firm, should count on being protected from failure. But no such statement will appear credible unless ways and means are found to ensure that the absence of the bail-out has no systemically disruptive consequences. Trying to find, and agree “globally” on such crisis resolution processes should rank very high on the political agenda. This does not seem to be the case.

****