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Central Banking, Financial Stability and Regulation

Ladies and Gentlemen,

Welcome to this session and a particular welcome to our distinguished speakers, Professor Elena Carletti and Giovanni Carosio.

The session is entitled "Central Banking, Financial Stability and Regulation". There is no need to emphasize that the crisis has put issues of financial stability to the fore. Yesterday, we already had ample occasions to discuss the impact on central bank strategy, namely how to combine or reconcile the macroeconomic objective of price stability with the objective of financial stability.

Today, we will go more into the details of how the financial stability objective could be achieved. What kind of new regulation do we need? In particular, how can regulation be made more intelligent? And what role should central banks play in the new regulatory and supervisory environment?

Let me briefly summarize what I consider the main lessons from last years' events.

1. The financial crisis has made us painfully aware that in order to preserve financial stability, not only is a thorough analysis at the level of individual banks necessary, but also greater consideration must be given to the linkages within the financial system and the associated risks. In short, the crisis has revealed the fundamental importance of systemic risk.
2. The crisis has also revealed the shortcomings of the Basel II framework for capital regulation. As it turned out, when push came to shove, banks had too little high quality capital at their disposal, were too highly leveraged, and had neglected the risk that the liquidity in funding markets might suddenly dry up.
3. Finally, the crisis has had a substantial impact on all major economies and has clearly demonstrated the limits of national responses in dealing with the activities of cross-border, systemically important financial institutions, markets and instruments. This is particularly evident in the European Union where financial markets have integrated rapidly and cross-border entities have become much more important since the introduction of the euro, while at the same time the EU's supervisory framework has not kept pace, remaining fragmented along national lines.

The reform proposals that are currently being debated at the European level try to address these fundamental weaknesses, namely the shortcomings in the Basel II framework, the geographical bias of nationally oriented supervisory structures and the micro bias of focussing on single institutions and neglecting systemic risks.

In order to link national supervisors, three new European authorities will start to operate with the beginning of 2011, dealing with banks, insurance companies and securities. At the same time the European Systemic Risk Board (ESRB) will deal with the exposure of the financial system to interconnected, complex, and cross-sectoral systemic risks. The ESRB will monitor and assess risks to the stability of the financial system as a whole. Additionally, the Board will provide early warning of systemic risks that may be building up and, where necessary, issue policy recommendations for action to deal with these risks.

However, we should keep in mind that what is difficult in macro-prudential supervision is less its design than its implementation. Concerning the ESRB, the vital question will be the binding strength of recommendations. A further challenge for effective macroprudential supervision concerns the quality of recommendations themselves. Here, the key lies in their specificity. The more specific recommendations are, the easier is their implementation in concrete actions. Concerning the effectiveness of cooperation between central banks, supervisors and regulatory authorities, which is relevant both within countries and across borders, the timely exchange of information is crucial. Moreover, the success of regulatory and supervisory reforms will depend largely on the right balance between regulation and freedom of markets. New rules should not impair the viability and innovation of financial markets and thus prevent economic growth. Furthermore, the rules for all financial market participants have to be harmonised internationally and across borders to avoid regulatory arbitrage. I appreciate the leading role of the EU in the regulatory reform discussions. However, it is of fundamental importance for the competitiveness of the EU that reforms are adopted in an internationally coordinated way.

With these introductory remarks, I would like to hand over to our two speakers. As in yesterday's session again we have a practitioner and an academic economist. I am very much looking forward to an interesting and fruitful exchange of views.

I am very happy to welcome Giovanni Carosio. Giovanni is a member of the Governing Board of the Banca d'Italia, and he will talk on the topic of "Financial Stability and Macroprudential Supervision: Challenges for Central Banks".

Our second speaker, Elena Carletti, is professor at the renowned European University Institute in Florence. Elena will speak on "An Overview of the Crisis: Causes, Consequences and Solutions".