CONFERENCE IN MEMORY OF TOMMASO PADOA-SCHIOPPA

FINANCIAL SYSTEM REGULATION AND SUPERVISION

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It is almost impossible to try to summarize in a few pages the contribution that Tommaso Padoa-Schioppa has made to the development of the theory and of policy-making in the field of financial regulation and supervision.

However, we can take as our starting point the essays collected in the volume Regulating finance*, originally published by Oxford University Press in 2004 and now available in Italian with two very important additional chapters on the causes of the recent financial crisis and on the need to revise Europe's financial architecture.*[1]

Among many issues, five can be selected, since they are of topical interest in the current debate on regulation and supervision: market-friendly vs. intrusive regulation; regulation and supervision; European financial integration and supervision; macro-prudential analysis; and central banks and financial stability. The fact that Padoa-Schioppa developed these views many years ago testifies to his forward-looking thinking.

1. Market-friendly vs. intrusive regulation [2]

This issue is constantly present in the works of Padoa-Schioppa and his views have informed the work of the Basel Committee on Banking Supervision (BCBS), which he chaired from 1993 to 1997.

He observed that the mainstream view in the 1980s and 1990s was that the benefits of pervasive regulation were outweighed by the costs to economic agents. In discussing the contribution of the BCBS to this policy issue, he argued that a good example of market-friendly regulation was emerging. Basically, while not leaning towards a laissez-faire model, the new regulation that was written in Basel was seen as a balanced solution, respectful of changes in market activity.

As an example of this market-friendly approach, he mentioned the possibility for banks to use their internal models for market risk (and subsequently for credit risk), in recognition of the fact that market participants are sometimes in a better position than the regulator to measure their exposure to risk. He, however, made a clear distinction between the market-friendly approach – which he saw as an inevitable and positive development – and the 'light-touch' approach of some supervisors. Indeed, he claimed that this latter view was too lenient towards a vision of self-correcting markets, a concept that he clearly refused.[3]

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[1] T. Padoa-Schioppa (2004), *Regulating finance*, Oxford University Press. Italian translation as *Regole e Finanza*, il Mulino, 2011.

[2] See the essays "Market-friendly regulation" and "Licensing banks" in *Regulating finance*, op. cit.

[3] T. Padoa-Schioppa (2010), *Markets and government before, during, and after the 2007-20XX crisis,* Per Jacobsson Foundation Lecture. In this lecture he noted that: "*[The view that] if financial markets are*

This market-friendly approach was criticized. For example, Goodhart, in the foreword to *Regulating finance*, noted that the use of internal models for credit risk proved to be dauntingly complex (and hence difficult to validate by supervisors) and that there was a risk of reinforcing herding behaviour by banks. Caruana (2010) noted that, while it would be wrong to deny the progress that has been made, risk management models failed to account for the real risk, not least because of wrong incentives and poor governance.[4]

Where do we stand now after the overhaul of regulation introduced with Basel III?

The financial crisis showed clearly that: the quantification of risk was overly optimistic and that internal models were (partially) inadequate to gauge market developments; the focus on capital was not sufficient to avoid disruptions and liquidity problems were a major driver of the crisis; and the rules in place somewhat increased the natural tendency of financial intermediation to be pro-cyclical.

The new regulatory framework addresses these problems with the introduction of: a leverage ratio as a backstop to contain errors in the models; new liquidity rules; and capital buffers to smooth pro-cyclicality.

These are major changes. However, does this mean that the underlying philosophy of market-friendly regulation has been abandoned? Probably not, given that the basic philosophy of previous Basel accords, namely the need to avoid as far as possible direct restrictions to banking activity that can induce distortions and be easily circumvented by the process of financial innovation has been substantially confirmed. Again, Padoa-Schioppa's thinking is illuminating as is shown by his discussion on narrow-banking proposals: *"Paradoxically, adoption of the narrow bank model could lead to a financial environment in which non-bank banks develop even further and uncontrolled and unsupervised risks spread even more."* [5]

We think that the main message that comes from Padoa-Schioppa's work in the field of financial regulation is the need to avoid the false sense of security that a certain regulatory framework could give to supervisors. Regulators, then, should keep abreast of market developments, thus confirming their scepticism towards self-correcting markets. Finally, even the best rules are powerless if there is no convinced and uniform enforcement at the international level.

2. Regulation and supervision [6]

In 2010 Padoa-Schioppa gave a lecture at the Per Jacobsson Foundation discussing the impact of the financial crisis on markets and governments. He said: "*I am one of those who think that supervision, not regulation, was the main problem: stronger enforcement of the existing rules (supervision) would have sufficed to avoid the disaster*."

'always right', they also possess a 'natural stability' [...leads to] the unwarranted conclusion that there is little need to subject the financial system to special regulations concerning products, institutions and market structures."

[4] J. Caruana (2010), *Financial stability: 10 questions and about seven answers*, speech delivered at the 50th Anniversary Symposium of the Reserve Bank of Australia, Sydney, 9 February.

[5] See the essay "Licensing banks" in *Regulating finance*, op. cit.

[6] T. Padoa-Schioppa (2010), op. cit.

Indeed, in certain jurisdictions the market-friendly approach was too friendly. At the roots of the financial crisis lies a misinterpretation of the light-touch approach. While it is indeed true that it was meant to reap the economic benefits of the process of financial innovation, this aim should not be an excuse to allow competition in laxity among different jurisdictions. He also noted: *"A policeman has to be friendly and helpful to citizens – just as regulators need to be market-friendly – but a policeman always has to remember who he is"*.[7] This is a useful starting point to evaluate the three main developments that we observed as a reaction to the financial crisis.

First, the new set of rules on systemic institutions introduced after the G20 summit in Cannes complements the Basel III reforms. Specifically, the measures to reduce the probability and impact of the failure of systemically important financial institutions (SIFIs) address one of the worries that Padoa-Schioppa highlighted in his 2010 lecture, namely the fact that after the crisis the financial industry has become more concentrated, with an increase in moral hazard for institutions that are "too big to fail". This implies that the proposals on SIFIs are a correct answer to the problem. However, in this field too, the implementation of the rules should be forceful, effective, and uniform at the international level. This is why the indications coming from the FSB on effective supervision and peer review processes are no less important than the new rules themselves.

Second, Padoa-Schioppa noted that after the financial crisis there was a risk of the market overshooting. He observed that the market had moved from obliviousness to alarmism over the capital adequacy of financial institutions. This risk is very real today: the push to front-load the new capital rules is very strong and is exacerbated by the increase in sovereign risk. Coupled with a deceleration in economic activity at the global level, this call for substantially higher capital levels risks being pro-cyclical and depressing economic activity still further. This is a clear example of the overshooting and undershooting phases of the markets that Padoa-Schioppa so lucidly explained. Policy-makers need to react to these tendencies as well.

Third, Padoa-Schioppa thought that the policy failure was due to the fact that the institutional setting at both the global and the European level did not keep apace with the evolution of banking activity. While he considered that the benefits of cross-border diversification of activities were a way of spurring competition and efficiency, at the same time he was well able to see the other side of the coin, i.e. the increased risk of contagion to other countries of a crisis stemming from one jurisdiction.[8]

3. European financial integration and supervision [9]

As Bini Smaghi puts it, Padoa-Schioppa provided a farsighted and realistic contribution to the design of the architecture for financial supervision in Europe, as he was convinced that in a single market the supervisory framework has to be a common

[7] T. Padoa-Schioppa (2002), *Reflections on recent financial incidents*, speech delivered at the Third Joint Central Bank Research Conference on "Risk measurement and systemic risk", Basel, 8 March.

[8] See for example, T. Padoa-Schioppa (2004), *The evolving European financial landscape: integration and regulation*, speech delivered at Colloquium organised by Groupe Caisse des Dépôts/KfW, Berlin, 22 March.

[9] See for example, T. Padoa-Schioppa (2004), *How to deal with emerging pan-European financial institutions?*, speech delivered at the Conference on Supervisory convergence organized by the Dutch Ministry of Finance, The Hague, 3 November.

one.[10] In his preface to the Italian edition of Regulating Finance, Enria observes that a recurrent theme of Padoa-Schioppa was the need to establish truly European (if not global) supervisory frameworks in order to cope with the systemic risks due to the interconnectedness of financial institutions and markets in different jurisdictions.[11]

Where do we stand on this?

The reform of the European supervisory architecture for financial institutions and markets was completed with the creation of three new micro-prudential authorities (the ESAs) and one macro-prudential authority (the ESRB). This reform marks major progress towards consistent supervisory practices.

Specifically, the European micro-prudential authority for banks (EBA) has the task of implementing the single rulebook. Padoa-Schioppa noted that: "*Strengthening the supervisory structure for multinational financial institutions means achieving two results: a single European rulebook aimed at ensuring equal treatment, low costs of compliance, and the removal of regulatory arbitrage; and an integrated supervision of EU-wide groups, resting on a complete pooling of information and the enhancement of the powers of the colleges of supervisors*".[12] However, supervision of large cross-border banks remains the responsibility of national authorities. As Padoa-Schioppa put it, the exchange of information among different jurisdictions and the powers of the colleges of supervisors have to be upgraded.

Especially in periods of crisis, such as the one that we have been experiencing since 2008, there is a tendency to retrench behind national borders. Indeed, the increase in sovereign risk and the contagion among various European countries have reinforced the transmission of shocks between banks in different jurisdictions. The new European authorities and the policymakers have to cope with this further aggravation of the financial crisis and act rapidly to protect the value of financial integration.

How to value the performance of the European micro and macro supervisors?

Progress has been made, but a great deal remains to be done. Much, however, depends on the willingness of European policymakers to cooperate in order to maintain the benefits of integration while at the same time preserving financial stability.

4. Macro-prudential analysis

After the financial crisis there was a flurry of contributions on the topic of macro-prudential analysis. Padoa-Schioppa noted that effective action has to rely on a rich analytical framework.[13] He also observed, and this observation is common to many other contributors to the macroprudential approach, that differently from the field of monetary policy, for financial stability there was a lack of a clearly established analytical and operational framework.

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[10] L. Bini Smaghi (2011), *Tommaso Padoa-Schioppa: economist, policy-maker, citizen in search of European unity*, European University Institute, Badia Fiesolana, 28 January.

[11] See T. Padoa-Schioppa (2011), op. cit.

[12] T. Padoa-Schioppa (2007), "Europe needs a single financial rulebook", *Financial Times*, 11 December.

[13] In T. Padoa-Schioppa (2010), he noted: "*Like a vessel, action stands out of the waves only if it is supported by the heavier, albeit invisible, body of an understanding of the forces of history, and of principles and goals helping to manage the opportunities and constraints embedded in the circumstances.*"

He fruitfully contributed to the advances in this field. He proposed his working definition of financial stability, which is "*the ability of the system to withstand shocks without giving way to cumulative processes which impair the allocation of savings to investment opportunities and the processing of payments in the economy*." [14] While the focus on system-wide disruptions that can impair the ability of the system to finance the economy is common to the definitions given by other economists and policymakers, he also stresses the preservation of the integrity of the payment system. This is very important, not only because, as has been recalled previously, Padoa-Schioppa's contribution to the definition of payment system oversight policies represented a milestone in this field, but also because it demonstrates his attention to the systemic risks stemming from the interconnectedness of financial institutions - an issue that is at the core of the current phase of the financial crisis.

As regards the analytical framework, while he concurred that the focus of macro-prudential analysis differs from the micro-prudential one, he also underlined the synergies between the two. For example, as regards the analysis, he stressed that a strict separation of the macro-prudential and micro-prudential dimensions is conceptually inappropriate and could even be detrimental. He was firmly convinced that these two dimensions were two sides of the same coin. As regards information, the crisis unveiled the presence of important data gaps. Indeed, one powerful way of increasing the information set for macro-prudential purposes is to leverage on micro-information: for example, the use of thematic on-site inspections has proved to be a powerful instrument for assessing the importance of common sources of risks and allowed for a homogeneous across-banks assessment of risk. Moreover, tools designed for micro purposes, such as the high frequency monitoring of the liquidity conditions of the main banks, are an important tool to shed light on the interconnectedness of large players.

He stressed the need to have an analytical framework able to provide early warning signals of crises, while at the same time recognizing that it is very difficult to spot in advance the build-up of imbalances. At the national and international level there have been fruitful discussions on the components of an early warning toolkit. If correctly used, stress testing techniques can be useful devices to increase resilience to shocks. It is not by chance, then, that in the European Union both micro-prudential and macro-prudential authorities have started to make extensive use of this tool.

He also stressed the need to have an appropriate communication framework so that the authorities responsible for macro financial supervision could send the right signals to the markets and to other policy-makers. In his view, then, the publication of Financial Stability Reviews was not a mere compilation of interesting facts about the financial system, but a policy tool, that he classified under the heading "Public comments", i.e. communication with the public.

Finally, he noted that prudential instruments aimed at contrasting systemic imbalances might be very similar to the ones used by the micro-supervisors (e.g. capital requirements, loan-to-value ratios, etc.), but that their concern was to avoid pro-cyclical effects. Here, the subsequent work of the Basel committee on the counter-cyclical capital buffer has made a major contribution. At the same time, the focus on the cross-sectional dimension of systemic risk, with the work on systemically important financial institutions, also goes in the direction of containing macro-prudential risks. These are

[14] T. Padoa-Schioppa (2002), *Central banks and financial stability: exploring a land in between*, speech delivered at the Second ECB Central Banking Conference, Frankfurt am Main, 24 and 25 October.

promising steps forward; in order to be effective, they have to be implemented consistently at the international level.

5. Central banks and financial stability

As a central banker, Padoa-Schioppa delivered numerous speeches on the relationship between monetary policy and financial stability, an issue that has gained a lot of attention in the aftermath of the financial crisis.

First of all, on the role of central banks in financial stability, he frequently recalled his long experience at the Bank of Italy, an institution that has responsibility for both central banking and financial stability. He claimed that: "*central banking has three major components: monetary policy, the payment system and the stability of the banks.*"

On the relationship between monetary policy and financial stability, at the basis of his line of reasoning was the conviction that while monetary policy and financial stability measures have to remain distinct, the objective of price stability is not possible without financial stability.[15] Indeed, the major crises in history are those that hampered the ability of the financial system to finance the economy. At the same time, he also noted that price instability is conducive to huge redistributions of wealth, which are subsequently reflected in financial instability. He also thought that at certain times there can be a trade-off between sound monetary policies and financial stability objectives (see the companion note *Monetary policy and payment systems*, by Angelini and Del Giovane), an issue that is extremely relevant today.

Moreover, he identified specific policy instruments that central bankers could use to address systemic risk. First, he identified an important tool in private and public comments, i.e. the ability of the policymaker, with his informed judgement, to influence market perceptions in the right way. In doing so, he anticipated one of the roles of the European Systemic Risk Board, for which warnings and recommendations are the main policy tool. He correctly warned that public commenting should be used prudently, in order to avoid undesired consequences and to maintain reputation and credibility, which are essential ingredients of effective policies. Second, he emphasized the operational standards in the payments system. Payment system functioning and regulation were at the core of his interests: he noted that given the high degree of integration, the malfunctioning of these systems might be one major source of financial instability. Finally, he believed in the importance of liquidity support and the coordination of private sector solutions. While emergency liquidity assistance remains a national responsibility, he forcefully noted that market operations aimed at preserving adequate liquidity conditions remain key among central banks' tools. This observation fits particularly well with the actions of central banks in recent years.

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[15] T. Padoa-Schioppa (2002), *Central banks and financial stability: exploring a land in between*, op. cit.