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**BUILDING AND PRESERVING TRUST –  
CHALLENGES FOR THE FINANCIAL COMMUNITY**

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## **Introduction**

A dinner speech should fulfil two criteria: It should not spoil the mood of the guests, and it should not be too long. Given that I will be talking about financial sector developments, this will be a very difficult task, but I will try my best.

I am delighted to be able to share my thoughts with you tonight and would like to thank the organisers for inviting me to do so. The International Chamber of Commerce has a long history of establishing international standards. I very much welcome this setting of standards, as it is the motor of further financial integration, efficient banking and sound management practices. However, in the light of the ongoing financial market turmoil, more rigorous thinking about banks' risk taking and risk mitigation could be on the agenda for the years to come.

In my speech tonight, I will talk from a euro area and ECB perspective. First, I will elaborate on the economic outlook for the euro area. Second, I will explain the clear distinction that we at the ECB, as well as many other central banks, make between our decisions on the level of the key interest rates and the provision of liquidity to banks. Taking a longer-term perspective, it is clear that both the private sector and the authorities worldwide will have to undergo fundamental changes in their modes of operation. Third, I will therefore give you my view on the challenges facing the private sector and then describe the follow-up responses of international institutions and authorities. I will close with a few words on the importance of continued progress in furthering financial integration in Europe.

## **I Euro area economic outlook, monetary policy stance, and the ECB's market operations**

The financial turmoil has affected the global economy. So far, however, the effect on the euro area economy appears to have been limited, the fundamentals of the euro area economy are sound. The latest information on economic activity confirms the picture of moderate but ongoing growth. Looking ahead, both domestic and foreign demand are expected to support real GDP growth in 2008. Although growth in the world economy is moderating, it is expected to remain resilient, benefiting in particular from strong growth in emerging market economies. In the euro area, capacity utilisation is high, profitability has been sustained and so far there have been no significant signs of supply constraints on bank loans. In addition, employment and labour force participation have increased significantly and unemployment rates have fallen to levels not seen for 25 years.

Nonetheless, this outlook for economic growth remains subject to an unusually high degree of uncertainty, as well as to downside risks relating mainly to a potentially broader impact of financial

market developments on activity than currently foreseen, and additional increases in commodity prices.

On the inflation side, the picture is less positive. HICP inflation currently stands at levels significantly above 3%, with inflationary pressures stemming mainly from increases in oil and food commodity prices. Looking ahead, the annual HICP inflation rate is likely to remain significantly above 2% in the coming months, moderating only gradually over the course of 2008. Risks to the medium-term inflation outlook remain clearly on the upside, due mainly to the possibility of further rises in oil and agricultural prices and of wage growth and firms' pricing power being stronger than currently expected.

The ECB's monetary analysis confirms the assessment that upside risks to price stability over the medium to longer term prevail. Money and credit growth are very vigorous in the euro area.

On 10 April, we decided to leave the key ECB interest rates unchanged. We are convinced that the current monetary policy stance will contribute to achieving the price stability objective and we remain strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term.

The ECB has made – in this period of financial turbulence too – a clear distinction between the decisions on the level of the key ECB interest rates and the provision of liquidity aimed at ensuring an orderly functioning of the money market. Therefore, with the start of the turmoil in August 2007, the ECB countered the tensions in the money market by changing the timing of the liquidity provision within the maintenance period and increasing its average maturity through additional longer-term refinancing operations. The ECB's measures did not add to the overall stock of liquidity and left the average supply of liquidity unchanged over the full reserve maintenance period.

Overall, thanks to its flexible design, the Eurosystem's operational framework has thus far proved to be resilient and effective in the current circumstances and the ECB has succeeded in steering the overnight rate close to the key policy rate set by the Governing Council.

## **II Challenges for financial institutions**

Let me now move to the key challenges for financial institutions and markets in general over the coming months.

I would like to start by stressing that it is my firm belief that many of the weaknesses highlighted by the recent events can be addressed by market-led initiatives and self-regulation. Nonetheless, it seems that regulatory measures are needed too.

**The first challenge is to improve market transparency.** The market correction has demonstrated the importance of the disclosure and valuation of risks.

In particular, better disclosure of risks, as well as accounting and risk management practices, is of the essence in the short term. In the medium term, financial institutions should identify key risks and disclose information that is relevant to major stakeholders.

The second **challenge** is related to the **valuation of complex structured credit products** – a task that has proved to be very difficult over the past few months. The current techniques are typically based on market prices, making them vulnerable to a change in investor sentiment.

To mitigate the problem, the market has to enhance valuation processes, in particular by finding ways to improve the quality of inputs to their valuation models, even in the event that market data are not available. Credible valuation techniques are fundamental for maintaining trust among counterparties.

The third **challenge** for banks is **to address vulnerabilities in their liquidity management practices.** Banks have relied increasingly on wholesale funding. This has rendered some of them vulnerable to a sudden disruption in the markets.

The recent experience has spurred committees, both at the international and the EU level, into carrying out important work on liquidity risk. However, it should be noted that market-led initiatives are also under way, for example those being led by the Institute of International Finance.

The **fourth and final challenge** that I will mention today is that **institutions should live up to their social responsibility.** This issue has also been highlighted by the European Commission, which is exploring ways to promote responsible lending in mortgage credit markets.<sup>1</sup> Socially responsible behaviour is key to creating sustainable value for all stakeholders. In the global and competitive financial markets of today, pressure for short-term results may have a negative effect on incentives. This is particularly relevant in a market characterised by information asymmetries.

Building, preserving and valuing trust is not an unattainable ideal, but one that can be concretely translated into business objectives and practices. Such an undertaking requires, among other

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<sup>1</sup> See the White Paper on the Integration of EU Mortgage Credit Markets, COM(2007) 807, 18 December 2007.

things, effective corporate governance arrangements that are supported by a strong corporate culture.

### **III Policy responses**

Let me now say a few words on the regulatory and supervisory follow-up that has taken place so far.

The global nature of the market turbulence requires enhanced cross-border consistency in financial regulation and supervision. Consequently, the identification of the key issues and the measures to be taken over the coming months is based on cooperation and a common understanding, both at the EU and the global level.

Let me start by addressing the **initiatives in Europe**, moving from the initiatives that are already under way and which will also have a positive impact in terms of addressing challenges and providing responses to the recent events in the financial markets.

The first strand of initiatives relates to **enhancing the framework for financial supervision**. The first full review of the functioning of the Lamfalussy process conducted by the ECOFIN Council in December 2007 revealed a general consensus among EU bodies that there is a need for enhancing the functioning of the Lamfalussy approach. In this context, a number of possible improvements have been agreed recently, including giving a European mandate to national supervisors; requiring national supervisors to take into account the European dimension in their work towards a more united implementation of EU regulations; strengthening the functioning of the various committees of supervisors; and reinforcing the supervision of cross-border financial groups. Regarding the latter, the enhancement of the role of supervisory colleges (which have been set up by the Committee of European Banking Supervisors for major EU banks) will be an important development in the pursuit of supervisory convergence, as well as a means for strengthening cooperation and improving the exchange of information.

Second, in April 2008, the EU central banks, supervisors and finance ministries adopted a **Memorandum of Understanding** on cross-border cooperation in financial crisis situations between supervisory authorities, central banks and finance ministries.

Coming back to the initiatives specifically addressing the recent developments, the European finance ministers have agreed on a road map for policy **responses to the financial turmoil**, with four main objectives: (i) improving transparency for investors, markets and regulators; (ii) improving valuation standards; (iii) reinforcing the prudential framework, including liquidity risk management; and (iv) improving the functioning of the market, including the role of credit rating agencies.

In parallel with the work at the EU level, there are **initiatives taken by global policy fora**. In this context, I would like to draw your attention to the work carried out by the **Financial Stability Forum**, which prepared its final report on strengthening the resilience of markets and institutions for the meeting of the G7 Finance Ministers last week.<sup>2</sup> In particular, the report calls for strengthening the Basel II capital requirements (particularly for structured credit products and securitisation activities), enhanced liquidity risk management, the effective prudential oversight of relevant risks, tighter standards for valuation and transparency, and changes in the role and use of credit ratings. Further policy recommendations include strengthening the authorities' responsiveness to risk and improving coordination, as well as enhancing the arrangements for central banking operations in crisis situations.

As you have noticed, the responses have been swift, both at the EU and global level, and are highly consistent with each other. This reflects the strong common understanding among the authorities on the key issues that need to be addressed over the coming months. The ECB is strongly supportive of these initiatives and will contribute to the pertinent work. I firmly believe that the international cooperation between the authorities will continue to foster financial integration, development and stability.

#### **IV The role of financial integration**

Let me finally reflect on financial integration in Europe, a challenge currently faced by both the private sector and the authorities. History has shown that the tendency towards national retrenchment may occur in times of uncertainty. I would like to use this occasion to stress the importance of continued financial integration in Europe. Besides improving efficiency, financial integration will make a marked contribution to stability in the long term. Integrated markets reinforce the shock-absorption capacity of the system, as they are more liquid and offer better opportunities for risk diversification.

The Eurosystem is strongly committed to fostering financial integration. As an example, I would like to mention three key projects in the area of market infrastructures that have progressed significantly over recent months. First, the European payments landscape reached an important milestone last November, when TARGET2, the Eurosystem's single shared platform for payments, was successfully launched. Another of the Eurosystem's projects, TARGET2-Securities, aims at concentrating securities and cash settlement in Europe on an efficient, single platform. The private sector has contributed considerably to the planning and design of these systems. For example, last

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<sup>2</sup> Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience, published on 12 April 2008.

year, around 300 professionals from over 90 institutions played a large role in the formulation of the user requirements for TARGET2-Securities. Finally, the Single Euro Payments Area, or SEPA, is of utmost importance to the integration of retail banking markets in particular. The project aims to make non-cash euro payments as easy, efficient and safe as they are today in a single country. This project is being led by the European Payments Council, the decision-making and coordination body of the European banking industry in relation to payments, and has been supported by the Eurosystem and the European Commission in a variety of ways. The official launch of SEPA in January this year introduced both credit transfers and a card framework. The SEPA direct debit will follow before the end of 2009.

## **Conclusion**

Let me briefly conclude. The ongoing significant market correction should trigger reflections on the functioning of the global financial markets. I support the global efforts to draw all the lessons from recent and more distant history in order to make practicable policy recommendations to the private sector and the authorities alike. At this point, I would like to once again stress the importance of the effective coordination of all initiatives in order to ensure consistency.

From the ECB's point of view, it is important to foster a financial system that is stable and able to create sustainable value for all stakeholders. In this respect, prime responsibility lies with financial institutions themselves, but the public framework also has a role to play in providing them with the right structure of incentives. The latter objective does not imply dramatic changes, but some adaptations to the public framework in terms of capital requirements and liquidity risk management are certainly needed. Finally, financial integration in Europe will contribute to stability in the long term and therefore must not lose its momentum. Let's all face the challenges that lie ahead of us.

Thank you for your attention.