



## **Systemic Risk: Too important to ignore**

**Conference organized by APB - Lisbon, 3 February 2012**

Closing session by Vítor Gaspar, Ministry of State and Finance of Portugal

It is a pleasure for me to participate in the closing session of this conference on Systemic Risk. I want to thank the President of APB , António de Sousa, for his kind invitation and to congratulate him on an excellent conference that brought together many of the most prominent authorities in this field: Carlos Costa, João Santos, Charles Kahn, José Viñals, Andrew Procter e Peter Nyberg.

“Systemic risk” is an expression that gained a prominent place in economic policy debates in recent years. Indeed, the Global crisis is a case study on how a shock to a specific financial market segment can trigger widespread financial instability, spread across borders and to economic activity. In the end, the sub-prime crisis marked the beginning of the deep and prolonged crisis that is still on-going.

In my presentation today, I will start by discussing the main sources of systemic risk. I will then relate them with the need for a comprehensive policy response, I will briefly continue with some remarks on Portuguese banking system building on the Governor’s opening remarks earlier in the Conference, and finally I will conclude.

### **1. Systemic Risk**

What is systemic risk? In the European System Risk Board legislation systemic risk is defined as “a risk of disruption in the financial system with potential to have negative consequences for the internal market and the real economy”.

What are the drivers of systemic risk? It is now relatively established that systemic risk has two main sources that reinforce each other:

- The first one arises from the inherent bias toward procyclicality of financial firms’ credit provision (and also of non-financial companies and households borrowing) and that result in aggregate risk exposure.
- The second source of systemic risk is the so-called network risk. The increased integration and interconnectedness of the financial systems resulted in a complex network of contractual, behavior and informational links that amplify shocks. Furthermore, due to the central role of the financial system in the economy, this complex network is extended to non-financial corporations, households and the government meaning that in a broader sense



systemic risk relates to the risk that instability in the financial system may cause significant adverse effects on economic growth and welfare. In the current crises, the failure of Lehman Brother is one of the most representative episodes of network risk as a driver of systemic risk.

Financial systemic risk is thus characterized by both time-related and cross-sectional dimensions. The time dimension relates to the evolution of systemic risk over time as the business cycle unfolds, changes in financial market conditions and asset and credit market bubbles. The cross-sectional dimension relates to the correlation of risks across financial institutions at a given point in time due to direct and indirect linkages across them.

The Global crisis demonstrated that the existing policy framework was not adequate to deal with systemic risks in the financial system as a whole. So the need to develop an appropriate policy framework that would reduce the likelihood of crisis and their impact became a fundamental priority.

## **2. *The policy response to the Global crisis***

The policy challenge posed by the Global crisis requires action on three points: first, prudential regulation and supervision policies; second, a crisis management and resolution framework; and third, rules and procedures at the national and international level, to ensure overall macroeconomic stability. The first two elements are connected because the effectiveness of prudential supervision crucially depends on the incentives of financial institutions in crisis situations.

Macroprudential policies are needed to address the two sources of systemic risks that I referred before: to identify and counteract amplification mechanisms that cause procyclicality and to mitigate the ability of internal shocks to spread quickly through interconnected institutions and markets. The idea is to mitigate these risks and to make the financial system more resilient to their effects. It focuses on the financial system as a whole rather than on individual institution. As stated by Jean-Claude Trichet at the launch of the European Systemic Risk Board:

“What is true for a part, or even for all parts, is not necessarily true for the whole”

In fact, financial stability is about financial system’s resilience. Financial stability is said to prevail when the financial system is able to withstand significant disturbances without disruption to its functions. These functions are:

- first, the provision of payments and transactions’ services;
- second, the allocation of savings to investment opportunities;
- third, the supply of instruments for risk diversification and risk sharing;



- and, fourth, the production, processing and dissemination of information relevant for financial transactions.

Prudential tools - regulation and supervision - can be used to target financial stability in the system as a whole. The range of potential instruments include capital requirements, loan-to-value ratios, rules on provisioning, accounting rules, information disclosure and risk management. For example, improving liquidity and capital standards should discourage excessive leverage and enhance the resilience of financial institutions during all phases of the business cycle. In addition, macroprudential tools could limit the build-up of more structural vulnerabilities that contribute to systemic risk, such as the accumulation of financial imbalances in the economy relating to the increase in leverage in specific sectors.

Equally important is to define the rules and procedures that apply in conditions of crisis or trouble. In particular it is crucial to put in place bank resolution and insolvency procedures. Supervisory authorities should be able to intervene effectively at an early stage to avoid the failure of an institution or at least to limit its problems. Efficient mechanisms for bank resolution should be in place to be used when early intervention fails to deal with a distressed organization. In particular it is important to reorganize the troubled institutions in the most cost-efficient manner for the economy and society, before it becomes insolvent. Where resolution measures cannot lead to viability, insolvency proceedings to ensure an orderly wind down should be used.

Since the beginning of the Global Crisis significant progress have been achieved in enhancing economic governance and surveillance: surveillance of the budgetary positions and coordination of macroeconomic policies were reinforced, the set-up of a permanent crisis resolution mechanism is on-going and the framework to safeguard financial stability was significantly strengthened.

Three new European supervisory authorities (European Banking Authority, European Insurance Authority and European Securities Markets Authority) and also the European Systemic Risk Board were launched. The European Systemic Risk Board was created to monitor systemic financial risks to the European Union. This body, when necessary, issue risk warnings and policy recommendations of action for the European Union as a whole, to one or more Member States, to one or more European Supervisory Authority or to one or more national supervisory authority. These are important step for an effective regulatory and supervisory framework for financial stability in an integrated financial system in the European Union.

Also of fundamental importance is progress achieved in strengthening macroeconomic stability. Such progress is nowhere more impressive than in the EU. A comprehensive package of initiatives – known as the *six pack* – is already in place and will show its relevance during the European semester (coinciding with the Danish Presidency of the EU). The recent agreement on the Treaty on Coordination, Stability and Governance increases the political and national status of the golden rule of Public Finances and of rules to reduce excessive public debt levels.

Both rules are accompanied by error correction mechanism requiring effective action. Jurisdiction by European and national institutions is foreseen. Europe is about to complete the major overhaul of economic governance required by the crisis.

### **3. *Recent developments in the Portuguese Banking System***

I would now comment briefly on recent developments of the Portuguese banks. In spite of adverse conditions, Portuguese banks strengthened their capital over 2011, meaning that they are now better capitalized than before the Economic Adjustment Program. In addition, the deleveraging process of the banking system is at an advanced stage. The pace and composition of the deleveraging process needs to be consistent with the macroeconomic scenario of the program and should not jeopardise the provision of adequate levels of credit to the economy. The credit to deposit ratio after having reached a peak of about 167% in June 2010 declined to 146% September 2011. This is the result from both higher deposits and of sizable asset sales (both domestic and foreign). In fact and in contrast to developments in other economies, Portuguese banks continued to evidence capacity to attract deposits, which is an indication of trust in the domestic banking system.

The recapitalization process of Portuguese banks is proceeding in line with the schedule. Bank capitalization is to be achieved in the first place through market-based solutions. The fact that Portuguese banks have been able to do so in 2011 is a clear indication of the overall financial strength the banking system. However, in the event that not all capital needs can be met from private sources, public funds are available from the back-stop facility created under the program. The Governor affirmed earlier today that the amounts available comfortably exceed the estimated capital needs.

### **4. *Concluding remarks***

The stability of the financial system is a necessary condition for sustainable growth and economic prosperity. The Global crisis highlighted key policy challenges that in the past were insufficiently attended and to which we need to give clear and forceful response.

In Europe the crisis has exposed significant economic governance shortcomings and deficiencies in financial supervisory and regulatory framework. Since the start of the crisis important progress was achieved in prudential and regulatory fields, in crisis management and resolution and, last but not least, regarding macroeconomic governance. In my view, this evidences that we are now better equipped to ensure a more resilience and stable financial system.

Allow me quote the words of Machiavelli from the famous chapter 25 of “The Prince”. He writes on the influence of fortune in the affairs of men, and how this is to be resisted. Machiavelli talks about fortune (risks) and how to manage it:



"(...) I will compare fortune to one of those violent torrents that flood the plains, destroying trees and buildings, hurling earth from one place to another. Everyone flees this torrent, everyone yields to its force without being able to stand up to it. As this is the torrent's nature, man should not neglect to prepare himself with dikes and dams in times of calm, so that when the torrent rises it will gush into a channel, its force neither so harmful nor so unbridled. The same is true with Fortune, who unleashes her force in places where man has not taken skillful precautions to resist her, and so channels her force to where she knows there are no dikes or dams to hold her back".

My key point is that we have been very busy building frameworks for stability - dikes and dams – neither the storm or the works are over, but progress has been made.

Thanks for your attention!