Insurance companies, pension funds and the new EU supervisory architecture

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Ladies and Gentlemen,

All financial gatherings in our current circumstances are important occasions to reflect on the past and future of finance.

Today's gathering is focused on insurance and pension funds, two very large segments of the financial markets. I am therefore very grateful to Dr Bernadino - whom I congratulate on his recent appointment as Chairman of CEIOPS - for the possibility to share some thoughts with you on the role of these segments in Europe's financial system and its emerging supervisory architecture.

I shall also look forward to learning about your own deliberations at this conference and the conclusions you draw from them.

Before we reflect on the future, let me say a few words about the present situation. The European Central Bank's Vice-President, Lucas Papademos, will present our latest Financial Stability Review and our comprehensive assessment of the financial sector in the middle of December.

As you might imagine, the assessment is particularly complex at this point. This is in part due to the considerable heterogeneity among financial institutions. But it is also complex, because there is a need to disentangle what might be called "self-sustainable stabilisation" from that which is purely due to the unprecedented programmes of official support for the financial system.

I would like to confine myself to the euro area insurance sector.

We note that despite the recovery in financial markets in the course of this year, most insurers still reported lacklustre financial performances in the first half of 2009.

This was mainly because underwriting continued to be challenged. High risk aversion among retail investors reduced the demand for life insurance products. At the same time, underwriting of other insurance products was adversely affected by the economic freefall of late 2008 and early 2009.

More recently, in the third quarter, we note that many insurers reported improved results.

We mainly attribute this to the recovery in financial markets. Yet there are reasons to be cautious about the durability of the recent recovery of insurers' profitability. The supportive environment for investment income is unlikely to continue once market conditions begin to normalise.

At the same time, underwriting income is subject to the existing downside risks in the overall macroeconomic outlook.

Although there are few solvency concerns facing the industry, there is no room for complacency in this environment. Insurers will have to be mindful of having sufficient capital buffers in place.

The role of insurance companies and pension funds for financial stability

Let me take a step back and consider the role of insurance companies and pension funds in financial stability.

In the continuing debate about categories of financial institutions, a distinction is sometimes made between "systemically important" institutions and "large and interconnected but not systemically important" institutions. In my view, large insurance companies and pension funds belong in the first category. They play an important role for the stability of the financial system.

Traditionally, insurers and pension funds have not generally been seen as being a significant potential source of systemic risk. The insurance and pension fund sectors are mostly regarded as relatively stable segments of the financial system. They are not seen as interlinked to the same extent as banks are, for example, in interbank markets and payment systems.

But the interaction between insurers and pension funds, financial markets, banks and other financial intermediaries has been growing considerably over time. Today, therefore, this traditional view needs to be challenged.

I would like to mention three main reasons why insurance companies and pension funds can be important for systemic financial stability: their size, their interconnectedness and the economic function of insurance.

Let me talk first about size. Insurers and pension funds are very large investors in financial markets. The growing role of fully-funded pension systems worldwide will increase this trend. Collectively within the euro area, their investment amounted to €6 trillion at the end June 2009.

Most of the time, given the typically long-term investment horizons of insurers and pension funds, they are a source of stability for financial markets. However, due to the sheer size of their investment portfolios, reallocations of funds or the unwinding of positions by these institutions have the potential to move markets. In extreme cases, that could put at risk financial stability by triggering large swings in asset prices.

Second, interconnectedness: insurers and pension funds have strong and important links with banks and with other financial institutions. Euro area insurance companies and pension funds hold about €435 billion of debt securities issued by euro area banks. This represents about 10% of the total amount outstanding of debt securities issued by euro area banks.

From a financial stability perspective, we need to have a good understanding of these linkages in order to assess the potential transmission of problems from one sector to another.

Third, the insurance function: insurers help safeguard the stability of household and business balance sheets by insuring their risks. The default of an insurer could cause financial distress in these sectors. As we all know, this is why insurers and pension funds are supervised.

I mention the systemic relevance of the insurance and pension fund sectors for financial stability, because I consider that the system benefits from their inclusion in macro-prudential oversight.

This is exactly one of the objectives of the envisaged reform of the European Union's supervisory architecture.

The new EU supervisory architecture

The proposed reform of the EU's institutional framework for financial stability is based on a macro-prudential and a micro-prudential pillar.

On the first, the macro-prudential pillar, I am pleased with the broad agreement on the establishment of the European Systemic Risk Board – the ESRB – to which the ECB will give its full support.

The main recent milestone was the Ecofin Council in October, which endorsed the current legislative proposals. I would like to pay tribute to the Swedish Presidency.

The European Parliament has started its legislative process. I have assured the Parliament of our continued assistance in the setting-up phase. At the same time, we are preparing on our side so that once legislation is passed, the ESRB can take up its work straight away.

On the proposals for the second, the micro-prudential pillar of the new framework, I hope that a political agreement will be reached soon.

In my view, the establishment of the three European Supervisory Authorities (ESAs) will represent a significant step forward to ensuring consistent application of EU legislation across Member States and a common regulatory and supervisory approach at the EU level.

I strongly support the opinion that the regulatory framework should be in place as soon as possible for all the new EU authorities.

I see three main benefits in the envisaged micro-prudential framework.

First, the power to issue legally binding supervisory standards will allow for the establishment of a single European rulebook. As you will recall, this was an idea of Tommaso Padoa-Schioppa, a former ECB Board member. Such a rulebook will help to eliminate the current differences in the national transposition of EU legislation.

Second, the proposed mediation and coordination powers should promote further convergence of supervisory action and practices. In this context, I would like to highlight the crucial role of the new supervisory authorities in fostering consistent and effective approaches within the colleges of supervisors.

The participation of their representatives in meetings of colleges should favour information exchange within and across supervisors' colleges. In addition, the establishment of common supervisory databases should enhance the efficacy of the supervisory colleges' action.

Third, in times of financial distress, the ESAs can be empowered to adopt decisions fostering a coordinated response by the national supervisory authorities. This can promote effective supervisory action in times of stress. As the financial crisis has shown, swift and smooth coordination among authorities is essential.

The ESRB

Let me say a few more words about the ESRB.

I expect the ESRB to make a substantive contribution on two main fronts.

First, the ESRB will enhance the public sector's ability to detect and assess systemic risk in the European financial system. This should be achieved by monitoring all components of the financial sector that have a systemic impact as well as the interplay between the financial system and the real economy. A sound understanding of the evolution of the linkages – the 'interconnectedness' – between financial institutions, financial markets and financial infrastructures will be a key element for the successful fulfilment of the ESRB's mandate.

Second, the ESRB will fill a gap which – as we know with hindsight – emerged in the run-up to the crisis. This gap consists of the difficulty of translating risk warnings into policy action by the competent authorities. I am confident that the recommendations of the ESRB have the potential to foster adequate policy responses.

I am aware that there is a wide debate about the scope and addressees of the ESRB's recommendations. In my view, the recommendations should primarily focus on the area of financial regulation and supervision and take a macro-prudential perspective. They should not address individual financial institutions. This is the competence of national supervisory authorities.

But the ESRB could recommend supervisory authorities to use supervisory tools under Pillar II. Examples of such tools are loan-to-value ratios, which are measures of liquidity mismatch.

Work is ongoing in international fora to identify specific macro-prudential tools. The recommendations of the ESRB could also identify systemically relevant components of the financial system or key parameters of measures to reduce the potential pro-cyclicality of regulatory requirements. The addressees of these recommendations could be the whole banking/financial sector or sub-sets of the sector.

As regards the governance of the ESRB, the proposed composition strikes a balance between the need for inclusiveness and the need for efficient decision-making and clarity of responsibilities. This is reflected in the fact that, while the heads of all central banks and supervisory authorities will participate in the discussions of the ESRB, only the central banking representatives, ESA chairs and the European Commission will have voting rights.

Finally, I should restate that the ECB and the European System of Central Banks stand ready to provide all necessary support to the ESRB so that the latter can perform its functions successfully. In doing so, the ECB will closely involve the national central banks and exploit synergies with existing central banking activities. It will also rely on the human and technological resources of the European System of Central Banks to the maximum extent possible.

The interplay between the ESRB and the ESAs

I will now turn to the interplay between the European Systemic Risk Board and the European Supervisory Authorities.

An effective mechanism for cooperation and information exchange between these authorities will be of utmost importance. It is a necessary condition for the new institutional framework to work effectively.

I see a number of areas of cooperation between the ESRB and the ESAs.

The first relates to the exchange of information for the detection of systemic risk. The ESRB will need the supervisory knowledge of the financial sectors. This knowledge can be provided by the ESAs and the national supervisory authorities through their involvement in the Advisory Technical Committee, which will support the ESRB.

The ESRB will also need data and information. The provisions in the legislative proposals provide for a smooth flow of information between the authorities in both directions, with full respect for confidentiality requirements.

A second area of collaboration relates to the assessment of the potential impact of the identified systemic risks. The ESRB's toolkit will include macroeconomic stress testing exercises. As the ESAs are also expected to coordinate stress tests, the ESRB will have to cooperate with the ESAs. The recent set of stress tests coordinated by the Committee of European Banking Supervisors, in close collaboration with the ECB and the European Commission, may represent a useful example.

A third area of cooperation concerns the formulation of risk warnings and policy recommendations. The ESAs as well as the national supervisory authorities will play a very important role in discussions regarding the ESRB. These discussions may potentially lead to the adoption of warnings and recommendations addressed to the supervisory authorities. In cases where recommendations are addressed to national supervisory authorities, the ESAs will play an advisory or contributing role.

Concluding remarks

The proposed new supervisory framework represents a great step forward.

The European Commission's proposals to enhance the EU's financial architecture are aimed in precisely the right direction. I strongly encourage that a political agreement is reached by the end of the year.

The new setup will provide a decisive contribution to financial stability in the EU.

To that end, the central banks stand ready to provide the envisaged support to the European Systemic Risk Board, just as I am sure the national supervisory authorities will be fully supportive of the European Supervisory Authorities. The smooth cooperation and exchange of information between the ESRB and the ESAs will foster the effectiveness and thus the credibility of the new framework.

This is a challenging time for all the institutions involved. I wish the CEIOPS all the best for today's conference and every success for the establishment of its successor, which will represent a quantum leap in the European Union's supervisory architecture.