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Address by the Governor of Banco de Portugal Carlos da Silva Costa[1]

"Evolution of the regulatory framework, financial stability and economic development"

1. The role of the financial system in economic development

There is no economic development without investment, there is no investment without financing.

Considering that neither financing capacity nor entrepreneurial capacity are homogenous across economic agents, financial intermediation mechanisms are required to foster economic development, i.e. **a financial system that captures and channels savings**.

The financial system has three major dimensions: the capital market; the banking system; and the insurance system, the latter more closely associated with risk coverage. The capital market and the banking system perform the intermediation between savers and investors, centralising the resources from the former and channelling them to the latter. This process has an important scale effect in mobilising savings – as the financing capacity at individual level is pooled and transformed into credit enabling the financing of large-scale investments – and involves the transformation of maturities and liquidity.

[1] Prepared for presentation.

Investment opportunities and choices are therefore magnified and the risk is distributed and taken on by a larger number of agents.

The **financial intermediation function of the banking sector relies on a relationship of trust between banking institutions and their customers**, because: savers entrust their savings to banking institutions; and investors are given assurance that over the next few years they can invest and expect return from said investment. This also assumes the trust of the general public and investors in the banking system as a whole.

Banks take risks – as part of their normal activity as investment financiers. However, where such risks are excessive they can lead to huge losses – not only for banks and their investors, but for the whole economy. In fact, a financial problem with a bank that undermines trust in the other banks may jeopardise financial stability and have serious consequences for the economy as a whole. **Thus, the financial system is of general interest, which is important to safeguard, and warrants regulation.**

Regulation plays a key role in reducing vulnerability and risk sources and in containing the costs of financial instability when it arises. Thus, a well-designed regulatory framework, by reducing the likelihood and the seriousness of adverse events, favours stronger, more stable and sustainable economic growth.

2. The regulatory and supervisory framework

The supervisor carries out its activity under a specific regulatory framework. The experience of the past few years has shown the **importance of segregating regulatory from supervisory functions,** i.e. distinguishing between the entity that produces the regulations (the regulator) and the entity that applies them (the supervisor). The preparation of the regulatory framework, the level of detail of regulations and their interpretation shall be a competence of the regulatory function, with the supervisory authorities responsible for carrying out their activity in compliance with the defined regulatory framework. **This segregation is crucial for ensuring a greater balance between powers and responsibilities, enabling proper accountability.**

An economy's regulatory framework reflects society's preferences in terms of risk protection. **These preferences evolve over time and in tandem with them the supervisory regulatory framework**. Historically, **regulations have evolved like the swing of a pendulum. When the pendulum starts swinging from a high level of regulatory requirements** – typically observed soon after an international financial crisis – it leans progressively, as economic expansion unfolds, towards lower levels of regulatory requirements.

In the wake of the Great Depression of the late 1920s, financial regulations were substantially strengthened. For instance, in the United States in 1933, the Glass-Steagall Act was adopted, imposing a separation between investment and commercial banking activities, and introducing a deposit guarantee fund. The tendency to tighten regulations persisted until the 1970s**. The oil crises/Great Inflation of the 1970s and 1980s, as well as the economic policy response, induced a paradigm shift, with markets being given a key role in economic policy.** Thus began a period of marked liberalisation of the financial system, based on the idea that **market self-regulation was sufficient to ensure its proper functioning**.

Therefore, in the subsequent period, namely during the Great Moderation, policy-makers and markets did not pay sufficient attention to the imbalances that accumulated in the global financial system, leading ultimately to the 2008 financial crisis. An illusion was created that price stability was a sign of macrofinancial stability (underpinning the prices of financial assets), that economic cycles had disappeared, that the validation of investment decisions by the financial market was a guarantee that they had an underlying rationale, and were sound, and that the risk-sharing mechanism provided by the financial system (originate-to-distribute model) was sufficient to mitigate risks arising from investments made. In the originate-to-distribute model, it was considered that in the event of default, financial market investors together would be able to absorb the risk that had been transferred off the banks' balance sheets.

However, **the 2008 economic and financial crisis made clear that the benefits expected from risk-sharing may not materialise ex post**, for instance, if the composition of flows is too risky and too vulnerable to abrupt changes in sentiment of international investors. Indeed, the mutualisation of risk did not decrease origination risk, it only made it less clear, leading to excessive risk-taking. In addition, **a large number of banks had very limited capital to absorb losses, namely due to the application of inadequate risk-weighting methodologies. Besides, banks were funded by large amounts of debt and had a balance sheet structure prone to liquidity problems, due to the high level of encumbered assets and the transfer of risk off the balance sheet.**

The intensity and swiftness of sectoral and geographical propagation, combined with the seriousness of the effects of the financial system crisis on the real economy, highlighted the weaknesses of the self-regulation approach followed in the previous decades. The crisis also revealed that the financial systems where the capital market predominates (like the United States) have a higher capacity for absorbing losses, which are immediately passed on to savers. In the systems with a markedly banking nature (like the European system), losses are transferred by banks, with an impact on a larger number of economic agents. In both systems, financial instability propagation varies in direct proportion to the economic agents' degree of leverage.

Thus, the crisis stressed the need for reform at various levels. In this context, **the paradigm shifted again, with the wider society asking for stricter financial and supervisory regulations.**

This led to a significant change in financial regulations, guided by two main concerns: **improve financial institutions' governance models; reduce their risk degree and create capital buffers to absorb risk, should it materialise**. This involved the following changes:

- Strengthening of banks' capital requirements in terms of quantity and quality;
- New rules on liquidity reserves and bank leverage;
- Stricter risk management and internal governance requirements;
- Bank resolution and recovery directive (BRRD), which marks significant progress in dealing with distressed institutions.

These changes are naturally based upon society's preference for a specific degree of risk protection. Currently, the idea is starting to emerge in the public debate that we have reached a point of overregulation and, consequently some proposals for deregulation are being put forward, in particular in the United States.

The problem facing the regulator is to find an equilibrium point between the concepts of financeable risk and risk that is acceptable to society. In particular, a response must be given to the following question:

Which financial regulatory structure can ensure a better equilibrium between financial stability and economic growth?

It should be taken into account that the greater the number of capital buffers imposed on the banking system, the higher the intermediation cost, decreasing the credit multiplier (evolution of financing for a given level of capital). Indeed, a minimum risk banking system means a maximum cost banking system and, hence, smaller capacity to finance investment. However, if it is accepted that the financial system has to take some risk, the regulations must lay down how society should react when risk becomes systemic, for instance, setting out the role of the different stakeholders in these cases.

In my view, **the equilibrium should take into account the following principles**:

- **A clear distinction should be made between regulatory and supervisory functions**;
- Regulations should seek to make **the financial system safer, but flexible enough** to fulfil its function as driver of economic development and adapt to new paradigms, namely to those resulting from technological innovation. Society's preferences in terms of financial security are not always consistent with the economy's financing needs or risk arising from innovation;
- The system should be designed so as to absorb **the failure of any institution, in particular by adopting a transparent and reliable loss absorption regime**;

- Financial institutions **should be sufficiently transparent – in terms of governance model** – so that authorities, managers and investors may understand and evaluate them;
- The system should ensure the quality of information (that should be complete and reliable) of accountability models;
- The institutional and regulatory framework should ensure better **coordination and articulation between all stakeholders**.

3. Shadow banking

The regulatory reform has mainly focused on the banking sector, which has pushed a number of activities towards less regulated and less supervised parts of the financial system.

The shadow banking system performs various functions similar to those of banks, namely the transformation of maturities and liquidity, the transfer of credit risk, and leverage. However, the entities in this system are not subject to banking regulations and supervision, have no access to central bank liquidity, and do not benefit from public backstops, such as deposit guarantee mechanisms. **It is important that these markets' customers are aware that protection levels are different from those of the banking system.**

In any case, as the transactions carried out by participants in this market are highly interconnected with the banking system**, contagion risks within the wider financial system are high.**

This means that the reform of the financial regulations must be completed and expanded to contain the risks of this parallel banking sector. In my opinion, these entities must be supervised whenever they have the capacity to grant credit based on resources taken from the public. We must be able to reconcile financial innovation linked to the technological evolution with supervision. In this context, a structure should be designed and implemented to obtain information from these institutions, a monitoring approach set up, and a macroprudential toolkit developed.

4. Conclusion

There are no zero-risk financial systems. Banking activity, to be socially useful, involves risk-taking. There is no financing of the economy without risk and no sustained economic development.

Each society must define and assume the level of risk it is willing to take. You cannot ask the financial system to take risks and, at the same time, to present no problems.

It is crucial to set up a regulatory and financial supervisory system able to balance the need to finance the economy and contain risks within limits considered acceptable by society. This involves putting in place a checks and balances system, including, namely, a framework of values, a framework of institutions, a framework of penalties on violation of rules, and a model to expedite the application of sanctions.

Finally, to be stable and safe, the financial system requires not only adequate regulation and supervision, but also needs banks and financial market players to act in an independent and responsible manner, in compliance with the highest standards of ethical conduct.