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The day after tomorrow: the future of financial intermediation

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Keynote speech by Carlos Costa, Governor of Banco de Portugal

High Level Roundtable on Resolution & Financial Stability

Ladies and Gentlemen,

It is a great pleasure to be part of such a distinguished roundtable on resolution and financial stability.

I am grateful for the National Bank of Romania's invitation to address you today on such timely and relevant topics.

The need for the financial system to have an effective resolution framework was a key lesson from the recent global financial crisis.

During the crisis, governments had to resort to 'bailouts' when banks that had become too big, complex and interconnected were at risk of failure. Letting them fail would have meant that households and businesses would have been unable to access their money, finance their projects or make payments. The possibility of contagion and the impact on the wider economy meant they had become 'too big to fail'.

Resolution aims to change this by providing tools to ensure that critical operations of the bank can continue and value is preserved while losses are absorbed by shareholders and creditors ('bail-in') with the aim of preserving financial stability.

Shareholders and investors profit when a bank is healthy and through such investment are obviously exposed to the risk of being affected when a bank gets into trouble.

This relationship between risk and reward also strengthens incentives for banks to demonstrate to their stakeholders that they are not taking excessive risks.

It is indisputable that the financial system in most advanced economies is now sounder than at the onset of the financial crisis in 2007:

- Funding of the core financial system (banks) is more stable,
- Leverage is more sustainable, and
- Banks are significantly more capitalised.

While reforms since the crisis have made the financial system substantially safer, it is not immune to risks, and the existing policy instruments are still not effective enough in addressing failing banks.

Today, many institutions cannot be deemed resolvable without extending the bail-in requirements to the level of senior debt or deposits.

Although one may argue that this is due to insufficient loss absorbency capacity, it is simply not reasonable to expect that compliance with minimum requirements for own funds and eligible liabilities (MREL) can be achieved in the short to medium term.

Resolution authorities need to be able to rely on alternative sources of financing such as resolution funds to finance the resolution of credit institutions, especially in the transitory period in which loss-absorbing capacity is not available.

However, the current internal loss absorption requirements (8% of total liabilities and own funds) and limitations on the amount of the resolution funds that can be used (5% of total liabilities and own funds) prevent their proper use.

In some situations, especially in the present building-up phase of loss-absorbing capacity (and eventual future transition periods), these thresholds may not be met. In those situations, resolvability would not be assured.[1]

This means it would not be feasible to resolve credit institutions while complying with the most basic purposes of resolution such as ensuring continuity of critical functions or avoiding significant adverse effects on financial stability.

The Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) have entered into force without the full recovery of the European Union's economies and without banks having significantly strengthened their ability to absorb losses.

Risks are augmented by the fact that we are running an incomplete Banking Union where a backstop to the Single Resolution Fund (SRF) and a European Deposit Insurance Scheme (EDIS) are still missing.

Consequently, the regulatory requirements underlying the BRRD and the Banking Union's current set-up may themselves contribute perversely, weakening banks and undermining financial stability.

Indeed, while supervisory and resolution decisions are taken at European level, financial stability remains mostly a national responsibility; this is so despite national tools having a much more limited scope, in a context where there is a clear misalignment between liability and risk control. We have recently experienced this first-hand in Portugal with the case of Banco Popular Español.[2]

It is thus essential to complete the Banking Union while properly aligning the interests of those entrusted with decision-making powers, those bearing liability and those with accountability, so as to ensure fair and balanced decisions.

In my remarks today, I will address four of the most pressing issues that we need to tackle urgently, namely: (1) solvency definition, (2) liquidity in resolution, (3) loss absorption capacity, and (4) safety nets.

1. Solvency definition

Proper incentives should be established for all the relevant stakeholders in the run-up to and after the adoption of a resolution scheme.

This starts with the definition of banks' solvency. Recent calls to reflect on how to define solvency, in particular its forward-looking aspect,[3] risk adding an unwarranted degree of discretion.

Such discretion, in turn, may cause an increase in the cost of debt and equity for European banks, whether large or small, since the relevant triggers for a failing or likely to fail (FOLTF) determination would be difficult to predict and make uniform.

The solvency definition should be consistent over time and within the regulatory framework. It should be objective, traceable and reliable for third parties.

Solvency should also be viewed from a 'going concern' perspective, which is intrinsically associated with CRD IV/CRR provisions. The first, and main, step in solvency determination should be a point-in-time assessment of compliance with minimum capital requirements (Pillar 1 requirements).

Any 'forward-looking perspective' should only play a role if there are relevant future events which are known and quantifiable at the time of solvency determination, i.e. if these are certain to occur and their implications are quantifiable.[4]

Moreover, one cannot lose sight of the fact that resolution is a last resort measure, to be used when insolvency or default are imminent. This premise is the backbone of the whole framework and resolution should not be misused as a regulatory tool to keep banks disciplined or capitalised under more prudent standards.

2. Liquidity in resolution

Liquidity support for banks under resolution emerged as a key topic in the aftermath of the recent events in Spain and Italy.[5]

The Single Resolution Board (SRB) has recognised that work on identifying private and public sources of funding is a priority, including the potential role and limits of the Single Resolution Fund (SRF), the central banks and Member States.[6]

Also, the SRB and the Single Supervisory Mechanism (SSM) have called for the adoption of adequate moratorium powers for supervisory and/or resolution authorities covering all liabilities.

However, market participants have already recognised that the moratorium approach is only superficially appealing. It can have destabilising effects by amplifying incentives for a run on banks by investors, counterparties[7] and depositors[8] at the earliest sign of distress.

The moratorium tool can also lead depositors to withdraw remaining amounts in their accounts after the bank re-opens, a risk that can increase if depositors absorb losses during the resolution process.

Ultimately, moratorium powers risk spreading panic to the rest of the banking system, as other depositors fear the same will happen to them. *In extremis*, the adoption of capital controls could become inevitable.

Suitable alternatives need to be developed.[9]

In the run-up to resolution, there is a risk that the available collateral would be pledged for the most part. The provision of Emergency Liquidity Assistance (ELA) can reduce the availability of collateral during and after resolution.

In this sense, central banks and resolution authorities have a common interest in resolving banks in a timely manner, i.e. before asset encumbrance reaches uncomfortably high levels and collateral runs out.[10]

The potential use of Government Guaranteed Bank Bonds (GGBBs) should be assessed in a timely fashion in regard to the trade-off between extended liquidity support (via ELA and/or GGBBs), the resolution objectives and the implications for solvency.

In view of the existing mismatch between European oversight and national liability, the objectives and interests of the several stakeholders involved are not aligned.

As of now, we can ponder whether the intrinsic goal of preserving financial stability is being superseded by a self-protective interpretation of the European institutions' mandate.

This needs to change! Courageous decisions are needed.

To begin with, the SRF needs to be strengthened. Policymakers and the SRB should reconsider the policy of excluding *a priori* the use of the SRF in resolution plans (blanket preclusion) – this has already been called for by the IMF.[11]

Additionally, the provision and risk-taking of ELA for Significant Institutions should be shared by the Eurosystem instead of remaining at national level.[12]

Only by bringing the financial consequences up to European level where supervisory and resolution powers stand can we align the incentives of the several stakeholders.

Still, this would not be enough.

Even a well-recapitalised bank post-resolution may experience increased liquidity needs generated by market volatility or by asymmetrical information on the bank's viability.[13]

New tools should therefore be developed.[14] In this context, the pragmatic approach of the Bank of England to the provision of liquidity in resolution should be carefully exploited.[15] Consistency with the Eurosystem's counterparty framework and lender of last resort should be ensured.

3. Loss absorption capacity

The recent developments in Spain and Italy showed that investors will shy away from acquiring banks in an early stage of distress and wait for the opportunity to bid for these banks in a resolution context at distressed prices or under liquidation proceedings.

At the same time, in the current context where MREL compliance is far from being attained, whenever an event changes risk perception, short-term investors in that institution's 'bail-inable' securities will trample over each other to reach the exit before bail-in.[16]

As they form a disorderly queue at the exit, the price of these securities will collapse, triggering a series of contagious mechanisms including rating downgrades and ultimately bank runs,[17] potentiated by the corporate deposit base.[18]

This situation is conducive to significant transfers of wealth and the destruction of economic value that may seriously jeopardise financial stability.

Hence, the current status not only implies that resolution might be less effective than expected in safeguarding financial stability but also means that it might be creating perverse incentives and could potentiate runs.

Due attention should therefore be given when deciding on the quality and location of MREL as well as the corresponding phase-in period, bearing in mind the incentive structure of MREL investors.

Moreover we must be cognisant that it is simply unfeasible for the banking sector collectively to issue the significant amounts of loss-absorbing instruments required in the short to medium term, and that such requirements cannot be met without the risk of aggravating banks' funding costs and profitability.

In this context, due care should be given to public announcements about MREL shortages and timings.

Any indication that banks could be under stress, such as a negative result in a publicly disclosed stress test, may propel or accelerate the exit of senior bondholders and uninsured depositors (institutional, public sector, large corporates and to some extent SMEs), to avoid bail-in. Ultimately this puts the bank(s) at risk.

4. Safety nets

In the aftermath of the crisis, to reduce the risk of moral hazard and protect the taxpayer from shouldering private sector losses, there was a strong impetus against using public money in establishing a safety net for the financial system. Bail-in principles in resolving banks prevailed, as well as a general aversion to bailout provisions.

While this should be the norm, flexibility should be preserved as the financial system's network structure plays a fundamental role in deciding whether there is the need for a government to intervene or for a rescue to be fully sourced within the financial sector.[19]

By limiting policy options on the usage of public funds, legislators and regulators may have ended up exacerbating risks in the event of a (systemic) crisis.

Such misjudgement has not gone unnoticed and does not come without consequences.

In the aftermath of the events in Italy over the last few months, a growing view emerged that the credibility of the Banking Union was under threat.

Some noted that in the future, investors, when faced with similar situations, will find it hard to believe in the envisaged single rulebook and in the consistency of the resolution framework as they perceive bank resolutions will always wipe out subordinated creditors in full, and will stop short of bailing in senior creditors.[20]

We have also witnessed that costs are still ultimately borne at national level, contrary to the whole purpose of the Banking Union.

On the other hand, others have highlighted that the Italian cases showed the system could bend rather than break when challenged. It was a demonstration that (i) banking crises require solutions and tools that create confidence and allow for time to gradually recover value, and that (ii) public intervention must not be demonised.

Ultimately, the incomplete set-up of the Banking Union and the full implementation of the resolution regime are a dangerous combination that calls for a comprehensive re-thinking of the existing framework of safety nets[21] – especially when monetary and fiscal policy have limited room for manoeuvre.

Let me conclude.

One should not underestimate how much has been achieved since the 2007 crisis. Nevertheless, the foundations of the European architecture are still not sufficiently robust to withstand the impact of a future crisis and this should be the focus of policymakers and relevant institutions.

Decisive political will to move forward with the completion of the Banking Union is required. Otherwise, we risk fragmenting the single market and only realising we missed this opportunity when the next crisis hits.

Thank you for your attention.

[1] For further details, see IMF (2017), "Luxembourg: Financial Sector Assessment Program: Technical Note – Managing Problem Banks and Systemic Banking Crises", IMF Country Report No. 17/259, 28 August.
[2] See Nouy, D. (2017), "Banking union, three years on – has it lived up to its promises?", statement at the Single Resolution Board Conference, Brussels: "Banks are supervised and resolved at European level, but in the event of a failure, the negative consequences are felt mainly at national level. (…) If, for instance, the Spanish Banco Popular had actually failed, Portugal's deposit insurance scheme would have had to refund depositors in the Portuguese subsidiary. That is a consequence of having supervision and resolution at European level. The Portuguese authorities would not have been involved in either process."
[3] See Lautenschläger, S. (2017), "European banking supervision – achievements, challenges and the way forward", speech at the ESE Conference 2017, Vienna, 28 September.
[4] This approach is consistent with the BRRD, whereby (i) a deterioration of circumstances "in the near future" should only trigger the determination as Failing or Likely to Fail (FOLTF) on the basis of "objective elements" and (ii) the conditions for resolution are met if the failure of the bank cannot be prevented "within a reasonable timeframe".
[5] Restoy, F. (2017), "Recent regulatory developments and remaining challenges", presentation at the CIV Meeting of Central Bank Governors of the Center for Latin American Monetary Studies (CEMLA), Washington DC, 12 October.
[6] König, E. (2017), "Takeaways from the first application of the EU's crisis management framework", Views: The Eurofi Magazine / Tallinn 2017, September.
[7] AFME (2017), "AFME welcomes EC Communication on Completing the Banking Union", 11 October, available at https://www.afme.eu/en/news/press-releases/2017/afme-welcomes-european-commission-communication-on-completing-the-banking-union/
[8] Technological progress in finance and in communication have strengthened withdrawal risks, see: Clarke, S. (2017), "10 Years after Northern Rock – is the UK more or less likely to see another bank run?", 19 September, available at https://bankunderground.co.uk/2017/09/19/10-years-after-northern-rock-is-the-uk-more-or-less-likely-to-see-another-bank-run/
[9] Consistent with the Financial Stability Board's (FSB) Guiding principles on the temporary funding needed to support the orderly resolution of G-SIBs (Global Systemically Important Banks), available at http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D.pdf
[10] Knot, K. (2017), "Pendulums and pitfalls on the road to resolution", speech at the annual SRB Conference, Brussels, 29 September.
[11] IMF, op. cit.
[12] See Buti, M., Deroose, S., Leandro, J. and Giudice, G. (2017), "Completing EMU", VoxEU.org, 13 July: "Another important aspect […] concerns changes to the current set up for the provision of emergency liquidity assistance (ELA). This is still provided by national central banks, albeit after authorisation by the ECB. In our view, there should be symmetry between the level at which the ELA is provided and at the level at which supervision is carried out. This means that for banks under the SSM supervision, which would be typically operating across Eurozone countries, the responsibility for providing ELA should be at the European level, by the ECB."
[13] For further details, see IMF, op. cit. If plans for ensuring post-resolution liquidity funding prove insufficient, resolution authorities may need to take additional resolution actions, which would damage their credibility.
[14] Knot, K., op. cit.
[15] The Purple Book sets out the Bank of England's approach to providing a liquidity backstop in resolution, where required. To supplement the existing liquidity arrangements, the Bank of England has put in place a new, flexible Resolution Liquidity Framework providing the tools to lend to banks which are in a resolution led by the Bank of England. Such liquidity may be secured against a wide range of collateral, building on the collateral eligible in Sterling Monetary Framework operations. The Bank of England's objective is to provide liquidity in sterling or foreign currency as required, at the necessary

scale and for a sufficient period of time to allow the firm to make the transition to market-based funding. The terms are set in a way designed to support the effectiveness of the resolution regime, incentivise the transition of the firm back to market-based funding, and protect public money. For further details, see:
http://www.bankofengland.co.uk/financialstability/Documents/resolution/aproct17.pdf

[16] Ubide, A. (2008), "Anatomy of a Modern Credit Crisis", *Estabilidad Financiera*, no. 14. Banco de España.

[17] See Persaud, A. (2014), "Why Bail-In Securities are Fool's Gold", *Policy Brief* 14-23, Peterson Institute for International Economics: "Faced with collapsing prices, and declining confidence, the rating agencies will downgrade bail-in securities. More stoic holders of bail-in securities who had resisted the urge to sell in the first wave will now be forced to sell as a result of investment mandates limiting the holdings of low-rated instruments. (…) However, there will be wider knock-on effects where these instruments are being used as collateral for other instruments or where their prices are used to price other, less liquid, assets. Hedge fund clients will bolt for the exit, forcing hedge funds to raise liquidity by selling otherwise unconnected assets. These indirect effects will give an impression that strong, hidden undercurrents are driving financial markets, which will cause aggregate uncertainty to rise, triggering a general risk aversion and further liquidation of assets. There are many avenues through which the correlation of asset prices tends towards 1 during a period of stress. Collapsing asset prices will undermine the position of banks. Bail-in securities will bring forward and spread a crisis, not snuff it out."

[18] Banks with significant amounts of corporate deposits are more at risk as firms are more informed than retail depositors and understand better the risks of keeping large deposits in perceived fragile banks.

[19] Bernard, B., Capponi, A, and Stiglitz, J. (2017), "Bail-ins and bailouts: Incentives, connectivity, and systemic stability", VoxEU.org, 18 October.

[20] In the words of Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, "If bail-in debt couldn't protect taxpayers from a midsize bank failure when the global economy is stable, what are the odds it will work if a Wall Street giant runs into trouble when the economy looks shaky? Or how about when several giants are in trouble at the same time, as in 2008? Don't hold your breath." WSJ Op-Ed: "New Bailouts Prove 'Too Big to Fail' Is Alive and Well", 9 July 2017.

[21] See Geithner, T. (2016), "Are We Safer? The Case for Strengthening the Bagehot Arsenal", Per Jacobsson Lecture, IMF–World Bank Annual Meetings, 8 October.