FINANCIAL STABILITY AND MACROPRUDENTIAL POLICIES - MANAGING TURBULENT TIMES

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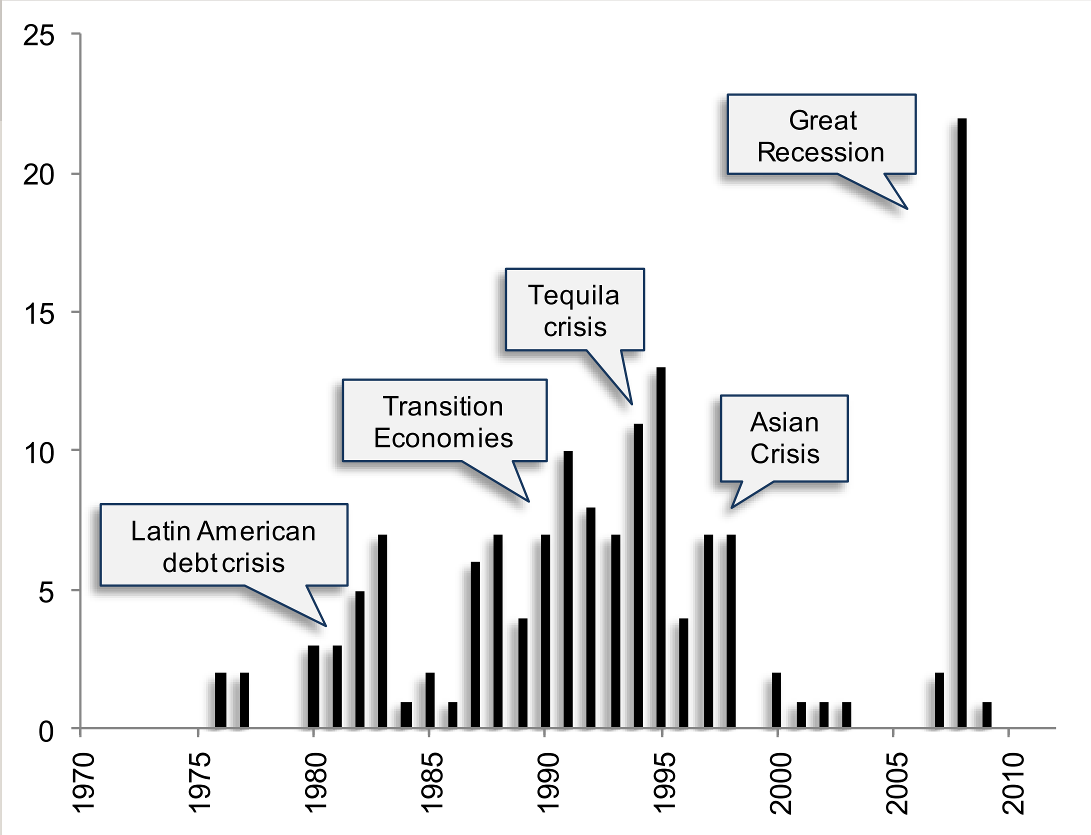
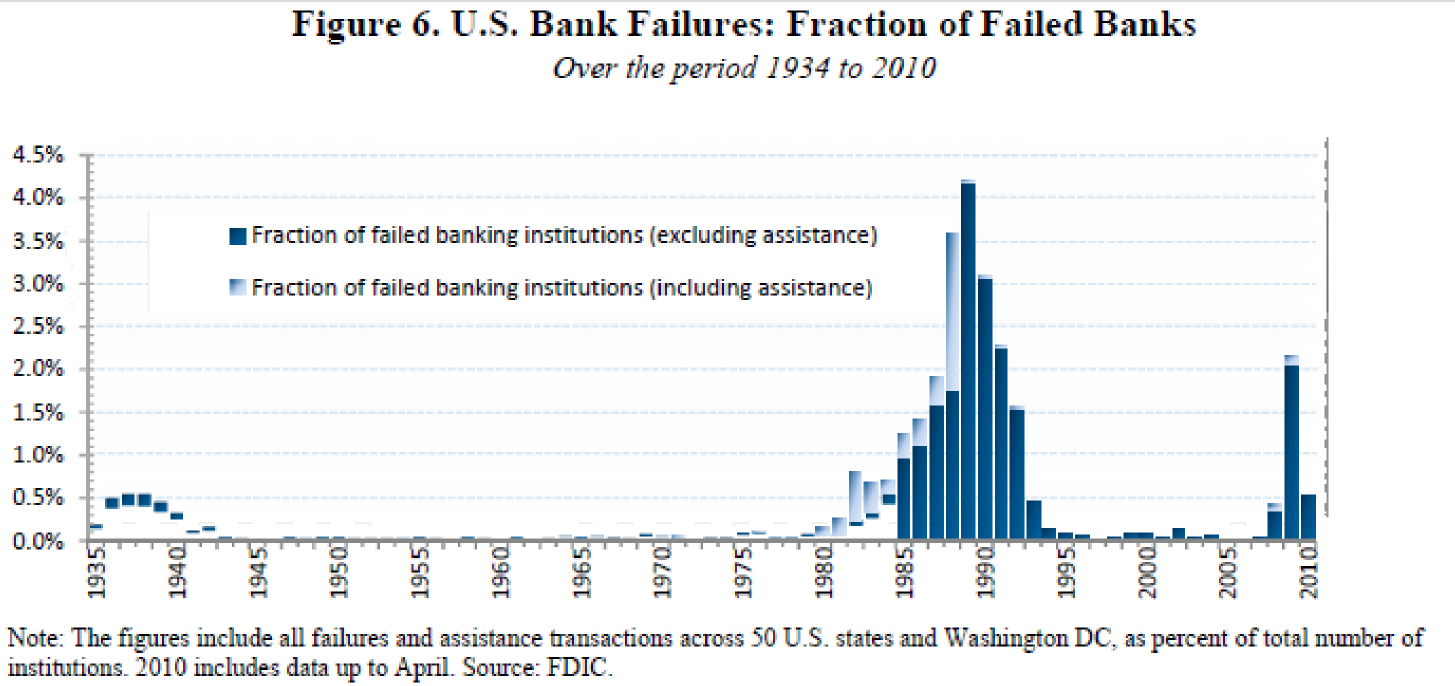
FINANCIAL STABILITY – SYSTEMIC RISK

- Financial stability can be defined as a condition in which the financial system – which comprises financial intermediaries, markets and market infrastructures – is capable of withstanding shocks and the unravelling of financial imbalances. *Source: ECB*

- Why do we care?
  - Disruption of credit flow and payment services can bring economies to a halt
  - Loss of access to savings can put depositors in precarious situation
  - Very high fiscal and output costs of banking crises (up to 55%)

IT NEVER RAINS, IT ALWAYS POURS….





VOLATILITY DOES NOT SEEM ELEVATED

IS IT THE CALM BEFORE THE (NEXT) STORM?

LIVING IN TIMES OF GREAT VOLATILITY

- Quick monetary tightening – can we go (back) home please?
- Bank profits going up with interest rates, but NPA ratio as well
  - In parentheses: bank 'windfall' taxes really seem the wrong tool to fill government coffers
- Increasing depositor mobility, with faster moving depositor runs – higher liquidity buffers, but also crisis management plans
- Threat of cyberattacks, reliance on third-party IT providers
- Geopolitical risks, in Europe and in Asia
- Elections, elections, elections!
- Unknown unknowns

THE ROLE OF MACROPRUDENTIAL AUTHORITIES IN TURBULENT TIME

MACROPRUDENTIAL POLICIES – THE OBJECTIVES

- Macroprudential policies have objective to
  - prevent the excessive build-up of risk, resulting from external factors and market failures, to smoothen the financial cycle or make financial system more resilient to the cycle (time dimension)
  - make the financial sector more resilient to failure of systemically important financial institutions and limit contagion effects (cross-section dimension)
  - encourage a system-wide perspective in financial regulation to create the right set of incentives for market participants (structural dimension)

  - How have these policies performed?

WHAT HAVE WE LEARNED?

- Macro-prudential policy can be successful if binding,…
- …but more so in upturn than downturn (asymmetry)
- Continuous challenge of leakages (foreign branches, NBFIs, fintech etc.)
- Borrower-based measures seem to work better than in lender-based measures for credit cycle effects; lender-base measures for resilience
- Differential effects across firms of different sizes and households of different income levels as well banks with different capital strength
- Consequently important distributional effects
- Actual measures not necessarily the optimal ones (complexity vs. robustness)

ASSESSING THE PANDEMIC MPP

- Capital release
  - Aggressive release of capital buffers (counter-cyclical, conservation buffers, Pillar II)
  - Objective: support lending to real economy
  - Successful, but not as much as hoped (important to focus on counterfactual)
  - Banks reluctant to reduce capital buffers too much (signalling to investors, future reversal, provision for future losses?)
- Dividend restrictions
  - Avoid risk shifting, preserve capital
  - Overall successful (debt up, equity down)
- To which extent should such policy measures become part of permanent toolbox? Should they be restricted to extreme, once-a-century situations?

LESSONS LEARNED FROM THE 2023 TURMOIL

- Rapid growth continues being a good fragility predictor
- Natural interest rate hedge due to banks' deposit franchise vulnerable to deposit runs
- Concentration of depositors, indirect linkages between depositors (common venture capitalist funder); more generally: business models important for fragility
- Most deposit runs a mix of solvency concerns and 'coordination failure'
- Speed of deposit runs (social media, access 24/7, instant payments) has increased

IMPLICATIONS FOR POLICY DESIGN

- Prudential treatment of interest rate risk in the banking book from the perspective of a fundamentally solvent bank should vary according to fragility of funding structure
- Too-big-to-fail is alive and kicking – hard to get around it
- Need mix of supervisory and market discipline
- Role of deposit insurance – trade-off between market discipline and inducing confidence and stability

THE ROLE OF SUPERVISORS

- Business models and governance structures matter!
- Interaction between capital and liquidity buffer might imply stronger reliance on pillar 2 requirements
  - trade-off of rules vs. discretion
- Stress tests that are severe, flexible, and appropriately transparent to improve measurement of capital….
  - …also: liquidity and interest rate stress tests
- Stronger focus on resolution and recovery! The more options to resolve, the fewer incentives to delay intervention….
  - Also has implications for communication

CRISIS MANAGEMENT AND DEPOSIT INSURANCE PROPOSAL

- More coordination between competent and resolution authorities
- Broadening of public-interest criteria
- Stronger role for DGSs in resolution process
- Remove priority of insured (and DGS when stepping in for insured) deposits over uninsured depositors
- Avoid limbo situations with zombie banks
- Overall, limited reform proposal, but even that has not been accepted politically

COMPLETING THE BANKING UNION

- From a limited to a real deal!
- Currently: resolution for the few, liquidation for none, if in doubt: preventive recapitalisation
  - Has push for bail-in gone too far?
- Needed: resolution for more institutions; flexibility that reduces incidence of bail-outs
- Strengthening of euro-area level resolution
- Progress needed on European deposit insurance and backstop
- Sovereign concentration limits

LOOKING FORWARD

- From banks to non-banks – increasing focus outside the banking sector
- Liquidity risks; do we need macro-pru liquidity measures?
- Climate risks:
  - just another macro-risk?
  - Higher capital buffers vs. need for more funding for green transition
- With digitalisation – new types of systemically important ~~financial~~ institutions
  - Cloud providers, platforms etc.?
- Distributional effects – trade-off: financial deepening vs. financial stability
  - Relates back to the political economy of MPP

FROM STABILITY TO EFFICIENCY - BUILDING A CAPITAL MARKET UNION

- Alternative funding channels for corporations, but also financial institutions
- Non-bank finance (both public and private capital markets) needed for financing transition to net zero!
- What is needed for CMU? Securitisation reform? Legal convergence? Tax reform?
- Capital markets display high degree of scale and network externalities – competition among national capital markets seems inconsistent with this
- Can we force transactions into the EU markets? Example CCPs – yes, we can, but what is the cost?
- Let a thousand initiatives bloom – CMU is not the non-banking equivalent to banking union

HOW DO WE GET THERE?

- Crisis as trigger for reforms (SSM/SRM after eurodebt crisis, CMDI package after US bank failures)
- Counter-forces: national politics; continuous search for national champions
- Search for big compromises and deals (quid pro quo)
- Example: CMU – need to raise substantial private funding for net zero transition; bank lending not enough (and most likely not well positioned), but development banks can play important role – combine!
- Do we need a champion for the CMU? Role of ESMA?

IN SUMMARY

- We are living in volatile times but are better prepared than in 2007/8
- But are we prepared for the ‘right’ shocks
- There has been a loss in reform momentum, but we cannot afford to wait until the next crisis
- Main long-term challenge: green swan and leverage private funding to support transition to net zero society
- New impetus for capital market union?
- Living in volatile times with high uncertainty requires a much more agile and flexible regulatoy and supervisory approach

SOME OPEN QUESTIONS

- Carefully calibrated policy tools vs. crude, but binding measures
- How can regulators/supervisors get ahead of market participants and regulatory arbitrage?
- Should technocrats rule?

THANK YOU

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