Luc Coene: The Belgian banking sector in 2020

Speech by Mr Luc Coene, Governor of the National Bank of Belgium, at the colloquium "The Belgian Banking Sector in 2020" in celebration of the 75th anniversary of the Belgian Financial Forum publications "Revue bancaire et financière/Bank- en Financiewezen" and "Droit bancaire et financier/Bank- en Financieel Recht", Brussels, 22 November 2011.

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The many lessons learned from the crisis that began in 2007–2008 have given rise to an ambitious, internationally coordinated, and broad-based set of regulatory reforms. The new regulatory framework not only strengthens requirements and supervision at the microprudential level, but it also incorporates new macroprudential requirements. Changes to the regulatory architecture have also led to the creation of new regulatory authorities, at both the European and Belgian levels. All of these developments will have significant impacts on the Belgian banking sector over the next decade.

1. Microprudential supervision – Basel III

Key elements, which are designed to increase banks' resiliency to shocks, include:

- ***An increase in minimum regulatory capital requirements***: the range of risks for which regulatory capital must be held has also expanded.
- ***Higher quality of capital***: an increase in the amount of capital that must be held in the form of common equity, which offers the greatest capacity for loss absorption.
- ***A leverage ratio***, which is a non-risk-weighted capital requirement that should serve as a backstop to protect against situations where risk-weighted capital requirements are too low (through underestimation of risks or regulatory arbitrage)
- ***Liquidity ratios***: the liquidity coverage ratio will ensure that banks can withstand a liquidity shock of 30 days in duration; the net stable funding ratio will ensure that banks have a sufficient amount of longer-term stable funding.

2. Macroprudential supervision

One of the striking outcomes of the crisis has been a change in the focus of prudential regulation, from a narrow concern with the resiliency of individual institutions to a broader preoccupation with the entire financial system. This concern has translated into the inclusion in the Basel III of new macroprudential capital requirements. It has also led to the establishment of a macroprudential authority in the new European regulatory framework.

New macroprudential capital requirements:

- ***Countercyclical capital buffers*** (CCBs) have been introduced into the Basel III framework, to address the time dimension of systemic risk. The level of countercyclical capital buffers, which will vary between 0 and 2.5% of risk-weighted assets, will be determined at national level for all credit exposures to counterparts in that country. When credit growth is judged excessive, national authorities will require banks to build buffers, which can then be drawn down in the ensuing downturn. The countercyclical buffer policy is reciprocal, meaning that all banks, even foreign ones, with exposures in a country must hold the buffer that has been set by that country's authorities.
- ***SIFIs***. Systemic risk also has a cross-sectional dimension, as illustrated in the crisis by the multiple instances where governments felt compelled to intervene with public

money to rescue large financial institutions whose failure could have transmitted distress to the entire financial system. On the one hand, failure of systemically important financial institutions (or SIFIs) would generate large costs that the institutions themselves do not internalize. On the other hand, belief that these institutions are too big to fail creates a moral hazard problem, weakening market discipline and providing the institutions with an incentive to take excessive risk. Both of these observations point to the need to find ways to allow such institutions to fail without injections of public money.

- At the global level, the Basel Committee is working together with the Financial Stability Board to develop a comprehensive approach to address the systemic risk created by global SIFIs. A methodology has been developed to 2.5%, depending–identify global SIFIs, which will face capital surcharges of 1 upon their degree of systemic importance. These institutions will be subject to enhanced supervision, as well as to the requirement to formulate recovery and resolution plans (or living wills).
- At the Belgian level, the NBB has developed a methodology for identifying institutions whose failure could have a significant impact on the domestic financial system i.e., domestic SIFIs. The methodology, in line with the international practice, focuses on the institution's size, its interconnectedness with other domestic financial institutions, and the ease of substitutability of the critical functions performed by the institution to gauge its degree of systemic importance.
- Domestic SIFIs will be required to submit plans for all strategic decisions to the NBB, which has the power to veto these decisions if they are judged to have a negative impact on the institution's risk profile or on the financial system. D-SIFIs will also have to comply with special reporting requirements and will need to develop recovery and resolution plans.
- The ***recovery plan*** – which is developed by the bank – outlines the different options that can be taken in response to a major shock to its liquidity or solvency. The resolution plan, developed by authorities, outlines options for cases where the recovery plan of an institution has not succeeded.

3. Resolution frameworks

- The focus on recovery and resolution plans highlights another critical area of regulatory reform: the improvement of crisis management and bank resolution frameworks. The crisis has revealed many obstacles to the resolution of cross-border financial institutions, and here is now a clearly acknowledged need to improve resolution regimes.
- Importantly, the effectiveness of crisis resolution framework also affects the behavior of financial institutions and their stakeholders, even in non-crisis times. If the crisis resolution mechanism is weak, leading to a high probability of government bailout of SIFIs that encounter distress, then stakeholders of these institutions will have little incentive to exert discipline on management, who may engage in excessive risk taking.
- In Europe, a legislative proposal soon to be published by the Commission should help to lay the foundations for a new crisis management framework. Key elements of the framework will involve the formulation of recovery and resolution plans (at least for large, cross-border institutions), enhanced resolution powers for authorities, and provisions linked to bail-in debt, which protects taxpayers by converting certain types of debt to equity at the point of non-viability of an institution.

- Authorities in several G20 countries are currently working with their credit institutions to develop recovery and resolution plans (RRPs). These efforts are being coordinated by the Financial Stability Board. Along similar lines, the European Council conclusions of May 10, 2010, relating to crisis prevention, management and resolution contain a requirement that Cross-Border Stability Groups (CBSG) coordinate the drafting of RRPs.

4. The new institutional architecture

- In response to the crisis, a new supervisory architecture has been established in Europe. This framework includes three new European supervisory authorities (ESAs) – for banking, insurance and securities markets – and the European Systemic Risk Board (ESRB), which is responsible for macroprudential oversight and based at the ECB.
- Each of the new supervisory authorities is responsible for creating a single rulebook, designed to establish harmonized regulatory technical standards and ensure a level playing field across the Union. The ESAs must also, in cooperation with the ESRB, initiate and coordinate Union-wide stress tests to assess the resilience of financial institutions to adverse market developments.
- The ESRB monitors and assess systemic risk with the objective of lowering the probability of a build-up of systemic risk or mitigating the impact of any materialization of systemic risk. The ESRB’s principal tasks include identifying and assessing systemic risks, issuing early warnings as risks emerge, and formulating policy recommendations in response to the observed risks. Warnings and recommendations can be addressed to the European Union as a whole, to one or more Member States, to one or more of the ESAs, or to one or more national supervisory authorities.
- The move in Belgium to the twin peaks model is in line with these developments. This adaptation of the domestic institutional framework allows for a regular flow of information between microprudential and macroprudential supervisors and for the coordination of micro and macro-prudential policies. It also permits application of the “four-eyes principle”, which incorporates a transversal approach to risk analysis, across risks, institutions, and time.

5. Impacts of these developments on the Belgian banking sector

As indicated by the previous speaker, the financial sector will face a very competitive environment in the search of stable financing. This will result in a number of consequences:

- ***More costly credit***. It is difficult to deny that the stricter capital requirements, combined with the new liquidity rules and new taxes, will increase the cost of credit. We do not yet know the extent to which this higher cost will impact aggregate lending or the real economy. However, the experience of the past three years has clearly demonstrated that banking crises are extremely costly and have significant negative, long-term impacts on the economy. The deleveraging process will reinforce this development. This is likely to affect more SME’s than larger corporations, that can still access the financial markets. This last development may lead to some disintermediation.
- ***Fewer cross-border institutions or activity, or less centralized liquidity management***. The failures of resolution frameworks revealed by the crisis and the difficulty of establishing an effective resolution framework for cross-border institutions suggest that cross-border activity will be reduced in the future.

Contributing to this development may be the new liquidity requirements, which could result in less centralized liquidity management by cross-border groups.

- At the same time, while some degree of explicit or implicit ring-fencing is an understandable outcome of the crisis, we must be aware of the fact that Belgium is a country with excess savings. We would not be doing Belgian banks a favor by forcing them to employ all of Belgian savings within Belgium. We will need to ensure that the new regulatory framework allows for an appropriate balance between limiting the risks associated with cross-border activities and allowing savings to flow to their most profitable uses.
- ***Industrial organization and SIFIs***. Another dimension through which the future structure of the banking system may be affected is related to the treatment of SIFIs. The identification of SIFIs involves gauging, among other things, size, market shares, and the degree of interconnectedness between banks. Limiting their size and interconnectedness, which SIFIs should have the incentive to do, will potentially lower concentration in the banking system and reduce the potential contagion that could result from a shock. Risk management for systemically important banks will also likely differ from the past, as SIFIs will be required to formulate recovery plans and regularly update them. Developing a recovery plan requires envisaging a series of scenarios involving severe shocks and the bank's possible responses to those the potential– in consultation with authorities –shocks, as well as assessing effectiveness of these responses. The recovery plan process must be ongoing and integrated into the bank's risk management procedures. This process should require banks to undertake more advanced planning for distress situations than in the past and should encourage a fundamental reflection regarding the rationale underlying the bank's activities, complexity, and organizational structure.
- ***Greater focus on traditional banking***. Several elements of the regulatory reforms (e.g., liquidity requirements and increases in capital requirements for the trading book) provide the incentive for banks to move more toward the "traditional" model of banking. While a requirement such as the ring-fencing of retail banking from investment banking proposed in the UK probably goes too far, a toughening of capital requirements for the trading book and greater alignment of capital requirements for exposures in the trading and banking book should give banks less incentive to take excessive risk through proprietary trading, thereby relying more on traditional banking activity. In smaller countries like Belgium ring fencing retail banks would be rather counterproductive. the main victims of such a reform could be the SME's. They need more sophisticated instruments than those retails banks can offer and they would be too small for investment banks. We have in Belgium a strong model of universal banking. We should preserve that.
- ***Less discretion by banks in the determination of risk-weighted assets***. Recent events, including the European stress tests and the sovereign debt crisis, have highlighted significant differences across banks and across jurisdictions in the calculation of risk weights and capital requirements for certain assets. This raises the question as to whether such outcomes are consistent with what was intended by the designers of the Basel framework. In coming months work will be initiated by both the Basel Committee and EBA to monitor the implementation of the new regulatory framework and to ensure that risk-weighted assets are appropriately and consistently calculated for exposures in both the banking and the trading book. This will likely result in more harmonization, at least among European banks, of IRB models for determining PDs and LGDs. Significant differences across banks in risk-weighted assets must arise as a result of true differences in risk and not from the underestimation of certain risks by some banks.

6. Challenges

- While it is possible to make some predictions about the changes in the Belgian banking sector in the coming years, several open questions remain, linked in part to the challenges associated with implementation of the regulatory reforms.
- One issue that we are all now acutely aware of as a result of the crisis is the fact that sovereign debt can no longer be considered to be a risk-free asset. It now becomes crucial for regulators to ensure that the credit risk of sovereign debt exposures is adequately recognized by banks. A reflection needs to be undertaken concerning the role of sovereign debt in regulation. Questions that will need to be addressed include the allowance of a zero risk weight for certain sovereign exposures (standardized approach allows zero risk weight for AAA and AA-rated sovereigns; IRB approach has no floor on sovereign PDs), the reliance of liquidity requirements on sovereign debt holdings, and exemptions of sovereign debt from large exposure rules. How these issues are resolved will obviously have an impact on the future composition of many banks' balance sheets. E.g. we see now that the liquidity cover ratio (LCR) as it is designed, discourages interbank lending.
- Other open questions relate to potential unintended consequences of the regulatory framework. To what extent will the tougher requirements on regulated institutions cause risks and activities to flow into the shadow banking sector and what will be the implications for banks and for systemic risk? Work is currently ongoing at the international level, under the leadership of the FSB, to strengthen the oversight and regulation of the shadow banking sector, and European authorities are also working on this issue. Yet, authorities will still need to remain extremely vigilant over the coming years in tracking the ultimate distribution of risks.
- Finally, many reforms are being introduced simultaneously. We do not yet understand fully the extent to which different reforms are complements or substitutes and, hence, what their cumulative impacts will be. The interactions between the various regulations must be carefully monitored, in order to understand the impact of the reforms on the financial landscape and to ensure that the goal of increasing the resilience of banks and the financial system are achieved at least cost.