Yannis Stournaras: Financial stability in Europe and how to improve it

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the Croatian National Bank "Financial stability and policy intervention by Central Banks in Europe – where do we stand and what challenges lie ahead", Zagreb, 23 March 2016.

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Before I begin my presentation, please allow me to dedicate the following remarks to the late Vassiliki Zakka, who was an exceptional colleague at the Bank of Greece and a dear friend. Before passing away unexpectedly several weeks ago, Vasso had contributed to the drafting of this speech. She will be badly missed.

Ladies and gentlemen,

It is a great pleasure to be in Zagreb today and to have the opportunity to share with you some thoughts on financial stability in Europe and, in particular, how to improve it. Financial stability is a critical condition for achieving our common goals of prosperity and sustainable growth. Yet, the financial landscape on which both regulators and market participants operate, has been rapidly changing; it is very different today from what it was only ten years ago, and it will be very different ten years from now.

I will begin by describing the present landscape on which efforts to strengthen financial stability have been taking place. Then, I will briefly discuss some developments in the EU regulatory framework relevant to the financial system and its stability. In particular, we can identify a new role for central banks in this framework that stems from mandates that have been revised to include the safeguarding of financial stability. I conclude by outlining the challenges ahead and I provide some thoughts on the way forward.

A. The setting – a broader context

Beginning with the initial efforts to forge closer European integration in the early-1950s, the European Union has faced a series of challenges that have, at times, tested both the coherence and the stability of the union. The responses to these challenges have shown that the EU is built on solid ground as the bonds among Member States have become stronger over time. To cite two notable examples: the breakdown of the Bretton Woods System in the early-1970s led to the creation of the European Monetary System – or EMS – in the late-1970s; the breakdown of the EMS in the early-1990s led to the creation of the euro in 1999.

Developments since the eruption of the 2007–08 international financial crisis have further strengthened the bonds among EU members. That crisis raised issues related to "too-big-to-fail", "too-big-to-save", and "too-complex-to-resolve". The Basel Committee on Banking Supervision, following the G20 agreement in 2008, took-on the task of comprehensively strengthening international bank-regulatory standards. Its updated report, presented to G20 Leaders last November, noted that substantial progress has been made towards finalizing post-crisis reforms and that the regulatory-reform agenda for global banks has almost been completed. Further clarification of these elements will provide regulatory certainty, supporting the banking sector's ability to make long-term sustainable business plans.

The euro-area financial crisis, which originated in 2009–10, provided another – more serious – challenge to the stability of the European Union. More recently, with the recovery in the euro area still fragile, a slowdown in growth in the Emerging Market Economies, along with a rise in geopolitical tensions, which have led to an unprecedented refugee crisis, and concerns about a Brexit, have led to an increase in uncertainty. Finally, different approaches among member states regarding banking union, and the slow progress in establishing a single European deposit insurance scheme, have been hindering further progress in securing the financial system architecture needed to enhance stability.

A salient characteristic since the onset of the euro-area crisis is that shares of European banks have been trading at a discount to tangible book value, while those of the largest US banks have traded at a premium to book value. This situation cannot be explained by differences in capital-adequacy ratios since capital ratios for euro-area banks have risen from about 8 percent in 2008 to about 14 percent today (Cœuré, 2016). On the contrary, these differences are indicative of a European banking sector undergoing a transformation that demands a comprehensive and radical adjustment of the core business model of operation.

The first two months of 2016 saw a sharp deterioration in market sentiment, related to not only a weakening of global economic activity, but also other concerns:

- First, the threat of low nominal growth, generating not only high NPL ratios but also lower and flatter yield curves with potentially negative effects on banks' profitability.
- Second, concerns about the effectiveness of monetary policy, with some market analysts believing that central banks may be running out of ammunition. I can assure you that they are not. The monetary-policy decisions by the ECB Governing Council two weeks ago provide clear confirmation of this fact.
- Third, regulatory uncertainty about the suite of capital and bail-in requirements – the Supervisory Review and Examination Process (SREP), the Minimum Requirements for Own Funds and Eligible Liabilities (MREL), the Total Loss Absorption Capacity (TLAC), and EBA guidance on the minimum distributable amount (MDA). Uncertainty as to the actual effects that can be expected from the newly introduced BRRD instruments seems to have played a role.
- Fourth, negative feedback loops between equity and debt markets, amplified by low secondary market liquidity.

B. The EU response

The responses of the European Union to the weaknesses to the financial stability landscape that emerged have been effective, despite the initial lack of crisis mechanisms and the unfavorable and challenging environment – an environment in which fires were often being simultaneously fought on a number of fronts. Initially, the response came in the form of monetary policy and a significant easing of the monetary policy stance. Indeed, in October 2008, six major central banks, including the ECB, executed a coordinated and simultaneous cut in interest rates. Additionally, at that time the euro-area countries set out an action plan of coordinated measures to restore confidence and improve financing conditions in the economy. These measures included the granting of government guarantees on bank debt issuance and the recapitalization of banks. With the eruption of the euro area financial crisis in 2010, and during subsequent periods when the monetary transmission mechanism was dysfunctional, the ECB increasingly implemented nonstandard monetary tools. Additionally, to provide financial assistance to countries under stress, in June 2010 Europe created the EFSF, which was replaced by the ESM in October 2012.

Perhaps the greatest challenge – and surprise – posed by the euro-area crisis was in the area of financial integration and banking. At the inception of the euro, it was widely-expected that the single currency would spur integration across previously-fragmented European financial markets. Economists believed that this integration would be stabilizing: portfolio diversification and access to credit markets were expected to encourage risk-sharing while making national demand less dependent on national income – that is, portfolio diversification was expected to encourage consumption smoothing. And for the euro's first ten years, that scenario unfolded very much as expected.

Then came a major surprise. The euro-area crisis revealed that countries within a monetary union can become subject to balance-of-payments crises – a possibility that had been almost completely overlooked by the architects of the euro. Moreover, once a crisis erupted – whether in the sovereign sector or the banking sector – a central feature of the crisis was the negative feedback loops between banking fragility and sovereign weakness. One factor contributing to those feedback loops was the following. Although the largest banks in the euro area and the United States are of roughly the same size in terms of euro-area GDP and U.S. GDP, respectively, the largest euro area banks represent a much larger share of any individual national economy in the euro area compared with the situation of U.S. banks. This circumstance implies that the fiscal consequences of euro-area bank failures could be large enough to bring state-solvency into question. Moreover, the fact that bank regulation and supervision prior to the crisis were mostly *national* was seen as having contributed to the crisis and as having impeded its effective resolution. Consequently, a key lesson of that crisis has been that a monetary union is not viable in the absence of a banking union.

In response to these developments, in 2012 European leaders initiated the creation of the Banking Union – which is an integral part of a genuine Economic and Financial Union in Europe. The three pillars of the Banking Union are: the Single Supervisory Mechanism, the Single Resolution Mechanism and the still-to-be completed common deposit guarantee system.

As of January 1st 2016, the Banking Recovery and Resolution Directive (BRRD), which sets common EU rules for failing banks, entered into full force. The BRRD aims, *inter alia*, to end the policy of bailing-out failing banks by introducing bail-in tools to ensure that losses are borne by creditors, including senior unsecured creditors. The BRRD, especially its bail-in tool, has been criticized – perhaps with some justification. However, the argument sometimes made, namely, that the activation of the BRRD has been a primary cause of the recent deterioration in market sentiment, including the large losses in European bank stocks, is far-fetched. The provisions of the BRRD have been widely known since 2014. What analysts, perhaps, failed to realize is that the new and stricter rules introduced with the BRRD will affect the volatility of the prices of banks' shares should concerns be raised about the banks' profitability, solvency and, most importantly, their viability.

That said, we must keep in mind that the BRRD is a new and untested framework for failing banks, and it is not particularly suited to addressing a systemic crisis. As it will be revised by June 2018, we will have to closely monitor its implementation and identify any areas where adjustments and fine-tuning will be needed.

While we may need tools for failing banks, our primary aim as supervisors is the ***prevention*** of bank failure, in order to foster financial stability and ensure that depositors remain protected. As John Vickers (2016) recently highlighted *"Orderly bank failure is better than disorderly failure, but it's best not to fail in the first place…Regulators… are adding usefully to the supply of fire extinguishers. With more fire extinguishers the average damage from a fire is materially reduced. But that is no good reason to economise on fire prevention".*

C. Central Banks and macro-prudential policy

Now let me turn to the issue of crisis prevention. The challenges facing EU financial sectors in recent years have significantly increased the responsibilities of central banks in the area of crisis prevention. Mandates have been amended to explicitly refer to financial stability – typically defined as avoiding rapid credit growth combined with increases in asset prices beyond those justified by the economic fundamentals – as a core central bank task. The toolbox for providing financial stability has been expanded to include macro-prudential policy tools and enhanced micro-prudential policy tools for both the national authorities and the SSM. Examples of macro-prudential tools include: a countercyclical capital buffer, a systemic risk buffer and the other systemically important institutions buffer along with measures to control, *inter alia*, leverage, liquidity and large exposures.

In the past, it was not thought to be necessary to separate monetary policy from the task of providing financial stability. It was thought that price stability in the market for goods and services would be sufficient to ensure financial stability in the market for assets. The experience since the early-2000s has dispelled such beliefs. That experience has shown that the business cycle and the financial cycle are not necessarily synchronized; long periods of disconnect between the two cycles can materialize. In particular, the financial cycle tends to have larger amplitude and lower frequency than the normal business cycle.

Macro-prudential policy bridges the gap between the micro-prudential supervision of individual banks and monetary policy. Its objectives are, first, to enhance the resilience of financial institutions and the entire financial system, and, second, to smooth the financial cycle. In this regard, macro-prudential policy allows monetary policy to focus on maintaining price stability so that real economic activity can flourish, while micro-prudential supervision focuses on individual institutions. In this way, macro-prudential policy enhances the institutional separation that is one of the principles of the architecture of the euro area. Indeed, I believe that a strong case can be made that, had macroprudential tools been available ten years ago, we may not have had a euro-area crisis. Ten years ago macroprudential tools to limit the excess borrowing that was taking place in the soon-to-be crisis countries were either not used or were too weak to dampen credit growth sufficiently in those countries.

That said, the usefulness of coordinating policies should not be forgotten – whether that be coordination of specific policies across different countries (as happened in the wake of the failure of Lehman Brothers with the simultaneous cuts in policy rates) or coordination of policies within one jurisdiction. Respect for the independence of the various authorities involved in securing financial stability should not imply separation and a lack of coordination. Thus, I strongly agree with Danielle Nouy that "micro-prudential supervision needs to be complemented by a macro-prudential perspective". It is imperative, however, that the macro-prudential toolbox be further enhanced with innovative tools beyond those focused on capital requirements. Cyclical systemic risk can arise not only as a result of excessive credit expansion (an issue that can be addressed with the countercyclical capital buffer) but also because of inadequate channeling of credit that keeps the real economy under-financed for extended periods.

A lesson drawn from the crisis is that we have focused on rather narrow areas of financial activity. Nowadays, it is important that we focus on the risks that might be missed at the micro level, that is the interlinkages between and among sectors, and thus explore how the financial system can influence, and be influenced, by the wider economy. In the euro-area, there is evidence of limited financing of the real economy, with the consequence that euro-area investment has not recovered to pre-2008 levels despite ECB policies directly aimed at increasing the lending of the banking sector.

D. Developments in the EU financial regulatory framework and further steps ahead

Apart from the elements of Banking Union and the BRRD, a number of other important regulatory initiatives have been taken, covering not only the banking sector, but also insurance, financial markets and infrastructures. Many initiatives are on-going and further steps are required for their completion.

If macroprudential policy is to effectively curb the financial cycle, it is essential to have tools that deal with the credit-real estate relationship. There are two ways to deal with this relationship. The first is by imposing restrictions on credit institutions – that is, through capital-based measures. The second way in which the credit cycle can be moderated is by limiting leverage by households and non-financial corporations.

With regard to the banking sector, the Capital Requirements Regulation (CRR) and Directive (CRD IV) play a prominent role in setting the prudential standards for credit institutions and investment firms in the EU. Implementation is ongoing and expected to be completed by 2019. From January 2016, the countercyclical capital buffer (CCB), the systemic risk buffer (SRB) and the other systemically important institutions (OSII) buffer have been operational. Given the need to diversify the available tools beyond regulations based on capital, tools based on liquidity, leverage and funding sources are also being introduced.

With regard to the borrower's side, instruments such as the loan-to-value (LTV), loan-to-income (LTI) and debt-service-to-income (DSTI) limits are considered to be among the most effective macroprudential instruments in curtailing excessive credit growth. In order to effectively moderate the financial cycle, a time-varying dimension is crucial in the design of the various ratios. For example, the loan-to-value ratio should be lowered during the expansionary phase of a financial cycle and it should be raised during the contractionary phase. Otherwise, there is a risk of pro-cyclicality since leverage constraints decrease as asset prices rise.

Regulatory initiatives for financial markets and infrastructures and the implementation of the European Market Infrastructure Regulation (EMIR) include macro-prudential intervention tools (such as an enhanced and cooperative oversight framework for central counterparties). Thus indicators that will contribute to better monitoring the extent to which the system is assuming more risks, as well as tools which can contribute to maintaining financial stability are being developed.

E. Challenges ahead and the way forward

Challenges, of course, remain. I will highlight seven of these challenges.

1. The first challenge is the completion of the Banking Union. Questions surrounding the financial capacity of the Single Resolution Fund (SRF), both in the short and in the long run, have to be addressed. The size of the SRF has been criticized for being insufficient and its governance structure has been criticized as being overly complex. If a sound backstop is not in place, there will be pressure for stress tests to become softer, which would be a detriment to financial stability. The ESM could become an effective backstop to the SRF, safeguarding financial stability in the Banking Union. Another issue that requires further reflection concerns the implications of implementing a single vs. a multiple point of entry in developing resolution plans. With respect to deposit insurance, aside from the Deposit Guarantee Scheme Directive (DGSD), the transposition of which is still pending in some Member States, the proposed European Deposit Insurance Scheme (EDIS) is of paramount importance. Deposit insurance at the supranational level will contribute significantly to financial stability by providing a back-up when national schemes do not have the capacity to handle large shocks. Such insurance will be a decisive step towards breaking the diabolical link between banks and sovereign and, along with a sound backstop to the SRF, safeguarding stability across the Banking Union.

It is also important to keep communicating with the markets. Thus, we have to provide consistent communication on regulatory initiatives and macroprudential policies to reduce regulatory uncertainty. It is necessary to revise the legislation and EBA Guideline regarding the definition of the Minimum Distributable Amount (MDA) to bring it into line with other countries. We need to harmonize the Minimum Requirements for Own Funds and Eligible Liabilities (MREL) and the Total Loss Absorption Capacity (TLAC), for example, by using the same definition of eligible liabilities for both tools and adjusting the relative thresholds. Close cooperation between the SSM and the SRB will be needed. One first area where this cooperation could be beneficial is at the level of the MREL. Finally, we need to promote strategies for banking sector restructuring while having a comprehensive strategy to tackle NPLs. This is particularly important for banks with high NPL ratios.

2. A second challenge ahead relates to the issue of the increased burden of complying with the new regulatory framework and assessing its cumulative impact. I am not referring to additional capital adequacy requirements. In the pursuit of making banks more robust, liquid, responsible and transparent, huge progress to regulate their operation and supervision has been achieved. However, there has been no estimate of the cumulative impact of these regulations. I welcome and look forward to the report on the impact of capital requirements on the economy; however, the impact of other regulations should also be examined.

We need to keep in mind the principle of proportionality. As new regulation accumulates, we know that it can come with costs as well as with benefits. Policymakers need to be watchful that, in attempting to limit externalities, they do not inadvertently create new externalities. The financial sector ultimately exists to serve the real economy. It is very likely that there are trade-offs between ensuring financial stability and imposing such a burden on the financial sector that it ceases to be able to do its job, namely to intermediate between surplus and deficit units in any economy in order to encourage long-term investment and growth. Thus we have to develop methods to judge the appropriateness of indicators and tools. Since many of the regulations have been applied over the last few years, that is, in a period of acute financial stress, I expect that in the coming years there will be a need to reassess those regulations and perhaps conduct some fine-tuning. Similar arguments apply to the national options and discretion in the new regulatory framework.

3. Closely related to the previous challenge is the degree to which regulatory developments should be front-loaded. The regulations themselves often have long phase-in periods such that new versions of the regulations are developed before the previous versions have been fully implemented. Supervisors have tended to compensate for the long phase-in periods by front-loading all prudential requirements, a situation that sometimes can be considered excessively harsh. Of course the long phase-in periods are often a reaction to the expected impact of the regulation on bank behaviour and, in particular, on the lending to the real economy. Some middle road has to be found.

4. A fourth challenge is the need to reduce reliance on models. Recently conducted stress-tests at the EU level followed a "single-model-fits-all" methodology, which left very little room for idiosyncratic and specific national characteristics. Moreover, according to some analysts, there is a risk that stress tests are becoming less effective as a supervisory tool. Instead, they may increasingly be seen as having been undertaken in order to calm the markets. Ideally, stress tests should be implemented in benign times in accordance with an old wisdom attributed to John F. Kennedy, that "the time to repair the roof is when the sun is shining". In crisis times, there is the risk that crucial inputs such as macroeconomic variables are under or over-estimated and that adverse scenarios become unrealistic – either too benign or too severe. In consequence, there are ambiguous outcomes that are difficult to interpret. Additionally, the potential pro-cyclical effects of stress tests should be explored. More appropriately, stress tests should not only place emphasis on solvency, but they should explore the impact of the assumed shock on bank liquidity, the implications of applying the bail-in tool, the funds needed to meet any demand on deposit guarantee funds, etc. We should focus on harmonizing processes, while models should be enriched with constrained judgement as is standard practice in macroeconomic forecasting.

5. Fifth, there is a need to widen the scope of regulation. A crucial challenge ahead is related to recent disintermediation and the development of "shadow" banking as an alternative means of financial intermediation. The CRR/CRDIV legal framework covers mainly the banking sector, yet financial activity and the financing of the euro-area economy have increasingly shifted to non-banks. The need for macroprudential regulation of certain financial activities becomes clear if we consider that banks and non-banks are closely tied through market-based intermediation activities. These include a broad array of services related to securitization transactions, securities financing transactions, repos, collateral management and derivatives. The consequences of poorly-monitored risks in this area are unknown and the risk of a new crisis could be lurking, while spill-over effects are difficult to assess. Moreover, the more that policymakers are effective in using macroprudential tools to constrain excessive credit growth in the banking sector, the more likely it becomes that there will be excessive adjustments in the non-bank sector through leakages. Fortunately, "shadow banking" is high on the agenda of the relevant fora and there is a clear need to extend the regulatory toolkit.

At this point I would like to mention also the Capital Markets Union. The Capital Markets Union aims at connecting saving more effectively to investment by funding projects in a transparent and ordered way. In this way, it could contribute to growth by providing alternatives to traditional bank intermediation for savers and investors. In pursuit of growth, Europe needs a financial system that is able to meet the financing needs of all economic entities (businesses and households) at different stages in their development.

6. A sixth challenge is one that the SSM has identified as a top priority for its supervisory action plan for 2016 – namely, banks' business model and profitability. In particular, low profitability in a low (even negative) interest rate landscape is a key challenge that banks need to address. Moreover, European banks have to address the problem of radical restructuring which has been delayed in many cases. This observation, accompanied by frequent top management changes, stands in contrast to strategy implementation in the US. It is even more complicated now with the deterioration in market sentiment and the weaker-than-expected economic outlook.

Part of the challenge in addressing a new business model relates to the increasing stock of Non-Performing Exposures (NPEs) and their management. These exposures are acting as a significant impediment to banks' reorienting their business model as well as, more broadly, to growth and financial stability, particularly in the countries of the European South. It should be highlighted, however, that we are in a good position to deal with this challenging issue as, thanks to the Comprehensive Assessment and the Asset Quality Review, we are aware of the full picture and important knowledge has been acquired for both monitoring and managing troubled assets. At the Bank of Greece, our research on the issue of NPLs indicates that they are overwhelmingly driven by recession. Thus, additional capital requirements cannot always provide a remedy. Indeed, in some cases such a remedy is likely to prove sub-optimal. Instead, at my Bank we have concluded that active private sector loan restructuring, the improvement in the insolvency framework, more efficient judicial systems and the involvement of loan servicers and private equity funds with experience in restructuring sectors of the economy are crucial components of an overall strategy of dealing with NPLs.

7. A seventh challenge, the role of the central bank as a lender of last resort to the banking system, needs to be addressed on the basis of principles that are consistent with our mandate of preserving financial stability. The principle developed by Thornton and Bagehot is well-known. Central banks should lend freely to solvent but illiquid banks against good collateral at a high rate of interest. How is this tried and tested principle to be made operational in today's environment with much larger bank balance sheets and fewer liquid assets? In the past, government bonds were automatically considered good collateral. Today, central banks accept a wider pool of collateral. By what criteria should collateral be judged? We know that liquidity problems can become solvency problems if liquidity is denied or not provided generously enough. Thus the seemingly simple principle developed by Thornton and Bagehot can be open to various interpretations. There is a need, I think, to revisit the question. Mervyn King's pawnbroker concept (2016) provides some new ideas on the issue.

The ultimate aim in meeting these challenges is to make finance in Europe more resilient and to enhance and safeguard financial stability. The role of supervisors of the financial system is to enhance harmonization while respecting proportionality. They should safeguard a level-playing field among all participants and protect depositors while striking the right balance between "strictness" and "fairness". Their mandate is to set clear boundaries within which financial intermediation can prosper while financial stability is maintained.

F. Concluding remarks

The financial sector is facing challenges on many fronts. Banks are no exception. Jonathan Hill (2015, 2016) recently spoke about "a brave new world for banks" and the need of a revolution in which banks are reformed and restructured with respect to both their business models and governance. Supervisors will also have to adapt to this revolution.

Despite the progress made in the past few years, with Banking Union as the flagship of the reform effort, more progress is needed as Economic and Monetary Union (EMU) remains incomplete. Divergence across the euro area is significant and the crisis of recent years has further highlighted existing shortcomings and important differences that need to be bridged. With respect to the financial system, we should seek an approach that promotes proportionality, transparency and competitiveness. Regulatory consistency, coherence and certainty are crucial to investors' decision-making process.

While financial stability is a necessary condition for prosperity in the euro area, it is not a sufficient condition. To this end, Europe should build upon other proposals outlined in the Five Presidents' Report (2015). As argued in that report, EMU will not be complete until the appropriate mechanisms to share fiscal sovereignty are in place. Monetary unions have to develop mechanisms for risk sharing. Mark Carney (2015) recently highlighted the stylized fact that, whatever happens to asset prices, debt endures. Reducing debt levels is difficult and he notes that it is unlikely that high debt in one sector or region can be reduced without at least temporarily increasing it in another. Fiscal integration can help in this respect. Allow me to remind you of Keynes's view about the Bretton Woods System – it needed, he believed, to provide mechanisms to promote symmetric adjustment within the fixed exchange rate area so that there would not be a bias towards deficient demand across the system. A more-fiscally-integrated monetary union would help address the problems of asymmetric adjustment and the deflationary bias of our monetary union.

Financial stability is a prerequisite for sustainable growth; it is also a fact, however, that financial stability on a sustainable basis cannot be achieved without economic growth. Failure to maintain sustainable growth has been the biggest threat to the long-term stability of the EU since the onset of the 2007 crisis. An appropriate balance between managing risk and enabling investment needs to be struck. In this connection, it is crucial that the regulatory framework does not impede, but provides a suitable environment, for sustainable growth.

Ladies and gentlemen, ultimately, a sustainable recovery will need to be underpinned by higher investment. Yet, in the euro area we presently face a significant investment gap. The financial system and its stability have a crucial role to play in closing this gap. Central bankers and supervisory authorities bear an enormous responsibility in shaping a system that can deliver prosperity to the citizens of Europe. We have made important progress in securing the financial stability needed to deliver such prosperity, but we have not yet completed the job. As the ancient Greek mathematician, Archimedes, once said, "Give me a place to stand and I will move the earth, but first I need a place to stand, a foundation." The completion of our financial-stability edifice will provide the necessary foundation for the citizens of Europe.

Thank you for attention.

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