

“Pendulums and pitfalls on the road to resolution”

Speech by Klaas Knot at the annual SRB Conference, Brussels, 29 September 2017

In his address to the visitors of the annual SRB Conference in Brussels, Klaas Knot touched on three issues:

- 1) linking resolution to the objectives of the ECB
- 2) the attractive but false metaphor of the so-called “regulatory pendulum”
- 3) funding in resolution

As rightly alluded to by previous speakers, a decade has passed since many of us lost our innocence. I certainly did! Ten years ago today I was feverishly working around the clock to design emergency safety nets and restore public confidence. The financial crisis fundamentally challenged how we regard the resilience of financial institutions. It also made clear that apart from stricter supervisory requirements, a solid crisis management framework was necessary. To that effect, The BRRD provided the tools, and the SRM regulation gave a central role to our hosts, the SRB.

I have been a keen supporter of the resolution framework from the outset. As a member of the FSB, I contributed to the development of the GSIB framework and TLAC standard. Significant progress has been made since then, for instance, in establishing the rules and building institutions, as you just heard. But much remains to be done. Making banks resolvable is clearly a journey. The key challenge is to stay the course.

Today, I would like to give you my perspective as a central banker on bank resolution. I will touch on three issues: First, I will explain why making banks resolvable is central to the objectives of the ECB. I will then counter the attractive metaphor of the regulatory pendulum, swinging towards looser regulation. Finally, I will address the elephant in the room called “Fury”, or funding in resolution.

The crisis revealed that the resilience of the banking system is vital to the functioning of monetary policy. If banks are not sound and their balance sheets are impaired, they cannot fulfill their critical functions, such as lending to the economy. This affects monetary policy transmission. It means banks’ capacity to pass on monetary impulses to the real economy is impaired. This can hinder central banks in pursuing price stability. Before the crisis, the interaction between monetary policy and the banking system was well understood. During the crisis, this interaction was starkly highlighted. The banking system failed as a channel of monetary policy impulses, and instead contributed to propagating shocks. Banks became mired in painful but necessary balance sheet repair efforts. As a result, they have been restrained in supporting economic recovery.

Banks’ crucial role in the financial intermediation of the euro area explains why many monetary policy interventions during the crisis were aimed at repairing the bank lending channel. The ECB was confronted with a systemic liquidity squeeze, and had to accommodate the funding needs of the banking sector. As such, we averted a self-fulfilling solvency crisis and resulting monetary contraction.

Nevertheless, many euro area banks lost their willingness and ability to keep pumping credit into the real economy. This required further flexibility in our policy framework, such as targeted long-term refinancing operations and a negative interest policy. Partly as a result of these extraordinary measures, the monetary transmission is working more smoothly. Lending rates have eased, and the credit supply has picked up.

To sum up, the crisis illustrates the importance of quickly restoring the banking system, both for the real economy and the effectiveness of monetary transmission. It has also exposed the limits and downsides of monetary instruments. Central banks can provide liquidity support but cannot restore the solvency of banks. Excessive reliance on central banks in fact delays the necessary adjustments. Cheap funding may prop up non-viable banks for too long, while making them less and less resolvable.

The significance of resolution for the monetary and banking unions is without question. In the euro area there are clear further constraints to resolving banking problems. Unlike the US, there is no single fiscal policy that can dampen shocks across Member States. And unlike the US, we do not yet have a single deposit insurance system that can provide confidence to all depositors, even if an idiosyncratic shock hits a particular Member State. Also, capital markets as alternative to bank intermediation are relatively underdeveloped compared to the US. Hence, to ensure the stability and sustainability of the euro area, making banks resolvable is essential.

As this session is about the road ahead for resolution, let me raise two specific issues for discussion.

The first one concerns pressure on regulators to soften rules designed following the financial crisis. It is often said that financial regulation moves like a pendulum, swinging back and forth between opposite states.

When a crisis occurs, there is a call for tighter rules, and the pendulum swings. Over time, as memory fades, there is a push for deregulation and fewer rules. Thus the pendulum swings back, possibly sowing the seeds for the next crisis. I would like to reiterate the concerns that my US colleagues Stanley Fischer and Janet Yellen have also voiced. Signs that ten years on, lawmakers now want to roll back post-crisis regulations, are troubling. The analogy of the swinging pendulum might be conceptually appealing, but it is overly simplistic. It suggests an inevitability and automaticity that should be resisted.

Let me take MREL as an example. The BRRD and subsequent regulatory technical standard developed by the EBA provided a good basis to determine MREL. On top of that, the FSB delivered the TLAC standard for G-SIBs. The FSB rightly added that loss-absorbing capacity should be subordinated and of sufficient quantity to truly shield taxpayers and depositors from losses, if we are serious about ending not merely reducing too-big-to-fail.

Now that we are close to setting binding MREL targets and are about to implement TLAC in Europe, I do see some classic symptoms of cold feet. There is no denying that pressure is mounting to soften the rules and their application. Concerns focus on impact, the costs to banks and the real economy of resolvability requirements on top of supervisory requirements. But in this discussion, the essence of the measures – the large benefits of resolvability to the real economy and society – tends to be neglected.

I do not claim that the resolution framework runs like clockwork. Here and there rules could be revised, without compromising their objectives. For instance, we need to consider current heterogeneity in the euro area. And think about solutions for banks that have large MREL shortfalls and lack market access. To those who claim that the MREL framework needs a major overhaul: please be specific. Then we can have an informed discussion about the pros and cons.

As I said, attractive as it may be in its simplistic inevitability, the image of the pendulum is ill-suited to breaking a paradigm like too-big-too-fail.

My second message to the panelists and the audience is to address the elephant in the room: “fury”, or funding in resolution. In theory, adequate resolution planning should enable the resolution authority to restore the viability and solvency of the entity under resolution.

As a result, the phoenix that rises from the ashes on Monday morning should be able to command market confidence right away. With this in mind, the BRRD explicitly requires resolution authorities to exclude the use of extraordinary liquidity support when developing resolution plans. In fact, the bank should ideally be able to repay any emergency liquidity support before resolution. It's all in the name: ELA is intended for emergency situations. After a credible resolution, one should assume that the emergency has been dealt with and that ELA is no longer needed.

That's why we need to address this elephant in the room. We need to tackle the issue of funding in resolution. New instruments may be needed. We can't assume that with their limited resources, the central bank or resolution fund will fully take care of funding in and immediately after resolution.

Even a well-recapitalized bank may experience increased liquidity needs generated by market volatility, and by asymmetrical information on the bank's viability. Market participants may be discouraged from providing liquidity – and existing creditors may be encouraged to run – if there is uncertainty over the new entity's ability to meet increased liquidity needs. For banks that are solvent and sound following resolution, the first port of call would then be the standard liquidity facilities of central banks.

Having said that, resolution authorities and banks cannot take liquidity support for granted. And prolonged support should in any case not be factored in ex ante as part of the solution. This is because, firstly, central banks will critically assess the viability of the bank post-resolution and need assurance that support would indeed be only temporary. Second, the bank needs to have sufficient eligible collateral, after haircuts, to access central bank facilities.

While this may seem obvious, there is a risk that such collateral has been largely pledged in the run up to resolution. In addition, the provision of ELA itself could effectively postpone the point of resolution, while further reducing the availability of collateral during and after resolution. In that 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.

In short, don't forget about funding in resolution. Sources of funding – including private ones – should be identified and prepared in tranquil times and quantified conservatively. Asset encumbrance should be closely monitored and timely intervention may be required to assure sufficient funding in resolution.

Let me briefly restate my main points. I gave my perspective as a central banker on the importance of resolution and the limits of monetary policy. To be ready for the next crisis – or rather to avoid it – we need to resist the analogy of a swinging pendulum. We must also be critical of relaxing post-crisis regulation such as MREL. I also identified funding in resolution as the critical missing link in the framework.

I wish you all pleasant and productive discussions. I trust that after today, you will be better equipped in your journey to make banks resolvable.