Carlos da Silva Costa: Opening remarks – "Conference on Financial Stability"

Opening remarks by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Bank of Portugal Conference on Financial Stability, Lisbon, 17 October 2017.

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Opening Remarks by Governor Carlos da Silva Costa

Good morning ladies and gentlemen,

It is a great pleasure to be here today to open Banco de Portugal's 2017 Conference on Financial Stability. On behalf of Banco de Portugal and the organising team, a very warm welcome to you all!

10 years past its beginning, academics and policymakers are still struggling to build a consensus on the policy implications of the financial crisis.

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

- Funding of the core of the financial system (banks) is more stable,
- An adjustment process leading to more sustainable levels of leverage took place, and
- Banks are significantly more capitalized.

Nevertheless, the financial system is not immune to risks, and the existing policy instruments are unable to fully address the persisting legacy of the crisis.

Moreover, 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 involving public money in providing a safety net to the financial system. Bail-in principles in resolving banks prevailed, as well as a general aversion to bail out provisions. While this should be the norm, flexibility should be preserved to address emergency situations.

By limiting policy options on the usage of public funds, regulators may have ended up exacerbating risks in the event of a systemic crisis. Jeopardizing financial stability will result in output losses and damaging consequences to the overall economy.

As investors rationally act to protect themselves against the possibility of haircuts to their claims on weaker institutions, the existing framework may actually accelerate runs and create a heightened vulnerability to a future systemic financial crisis.

The incomplete set up of the Banking Union in Europe with the full implementation of the resolution regime is a dangerous combination. Last week's proposal by the European Commission risks prolonging this problem. When seen in the context of the much smaller room for manoeuvre of monetary and fiscal policy tools, this threatens to leave us less prepared to deal with future crises.

Therefore, despite the reforms in financial regulation, and the upgrade in analytical and monitoring instruments, we should not convince ourselves that our ability to detect and curb the emergence of financial imbalances has reached a point in which we are in condition to avoid any financial crisis.

In the meantime, economic policy has acquired a macro-prudential scope, aiming at leaning against the wind, which includes several tools as the countercyclical setting of traditional measures of capital requirements and borrower based instruments.

However, macro-prudential policy is still quite recent and more research, namely on the instruments that can be used and on their potential impact, is still needed. The underlying 'buffers' were not built up before (and during) the crisis, additional tools still need to be developed, and more work is still needed to establish a comprehensive macro-prudential toolkit beyond banking, which to date is lacking.

Issues such as how to optimally coordinate policies and how to avoid time-inconsistency problems in this coordination are still outstanding. This is even more evident in a currency union where monetary policy affects the entire region, but macro-financial imbalances may be local in nature.

Today's Conference will address many of these issues by discussing:

- the main challenges imposed by this changed environment on financial institutions' profitability, behaviour towards risks and on overall financial stability;
- possible issues arising from the implementation of macro-prudential policy, such as: (i) defining the optimal policy stance, (ii) availability of policy instruments to mitigate vulnerabilities in the downturn of the financial cycle, and (iii) the interactions of policy instruments in the mitigation of systemic risk, and
- the most promising advances in research to overcome the existing limitations to the most commonly used methodologies in the analysis of systemic risks.

I thank you all for your participation and wish you a very pleasant and constructive conference.