Carlos da Silva Costa: Regulatory and supervisory institutional frameworks in Europe

Opening remarks by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the Seventh Bank of Portugal Conference on Financial Intermediation, Lisbon, 7 July 2017.

* * *

It is my great pleasure to welcome you to the 7th Banco de Portugal Conference on Financial Intermediation.

This conference series has taken place every other year since 2005 (when it was called the "Conference on Financial Fragility and Bank Regulation"). It aims to bring together senior and young researchers from academia and central banks to discuss the most recent developments in financial intermediation, markets and regulation.

Back in 2005, awareness of the challenges ahead in terms of financial stability was already increasing. Some key topics were becoming important in the theoretical and policy debate:

- rapid financial innovation in a context of international integration;
- liquidity management practice and the associated systemic risk;
- the role of central banks as lenders of last resort; and
- the set of problems related to "too big to fail" financial conglomerates.

When the international financial crisis began, followed by the European sovereign debt crisis and the vicious circle linking sovereigns and banks in several countries, these issues became a focal point. Many new topics also joined the research agenda, such as:

- the misuse of the so-called originate-to-distribute model, in particular resorting to complex derivatives and other opaque products;
- the pro-cyclical nature of the existing capital regulation framework;
- the adequacy of financial regulation and supervision frameworks.

Banks were forced to adapt their business models and management strategies. In particular, the very low interest rate environment and the unconventional monetary policies conducted by the main central banks dramatically changed the operating environment and the incentives for banks and markets.

At present, there are **four key issues that in my opinion deserve the attention of policy-makers and researchers**:

1. The regulatory and supervisory framework

An economy's regulatory framework reflects society's preferences in terms of risk protection. These preferences evolve over time and in tandem with them the supervisory regulatory framework.

In the aftermath of the recent crisis, the public asked for stricter financial and supervisory regulations. This led to a significant change in financial regulation, guided by two main concerns: improving financial institutions' governance models; reducing their degree of risk and creating capital buffers to absorb risk, should it materialise.

But more recently the idea that we have reached a point of overregulation has started to emerge in the public debate and consequently proposals for deregulation and arguments for greater supervision discretion have been put forward.

This discretion poses serious problems of transparency and of equal treatment, due to the temptation to shape the financial system by handing regulatory powers over to supervisory authorities. A clear distinction should be made between regulatory and supervisory functions. This segregation is key to ensuring a greater balance of powers and responsibilities, allowing proper accountability.

2. Regulatory arbitrage

The financial crisis also showed the limitations of decentralised supervision in a world of increasingly integrated financial markets and institutions. We are now in a process of moving from a situation in which the regulatory and supervisory frameworks were of national competence to a situation where there are common rules and in the euro area also a common supervisor.

A need for greater cross-border integration of financial regulation and supervision emerged from the policy debate and motivated the still on-going reform of Basel rules and the creation of the Banking Union in Europe.

However, the degree of implementation of the post-crisis global regulatory reform agenda across countries varies significantly, giving rise to regulatory arbitrage. This is reflected in the search for gaps in national legislation that justify avoiding compliance with previous international agreements, as well as in the behaviour of the authorities that accommodate specific requirements, conditions and interests of the major international financial conglomerates.

It is very important to identify and assess what the risks and cost of regulatory arbitrage are.

3. Regulatory flaws in the European regulation

The current Banking Union framework suffers from a critical weakness: its micro approach to managing banking crises disregards the financial stability risks resulting from interventions in ailing banks. The current resolution framework does not envisage a credible public backstop and lacks government stabilisation tools.

In fact, the framework governing intervention in problematic banks does not take into account the fact that the need to preserve financial stability must always prevail over the specific rules of intervention in banks. As recent cases illustrate, the European bail-in framework does not exclude bail-out events when financial stability issues (or the public perspective of it) are at stake. In addition, there is also the question of whether the lender of last resort is prepared and willing to lend all the liquidity that is needed when a bank is in distress but is still solvent. Otherwise, the trigger for a banking failure is not insolvency but illiquidity.

Another limitation stems from the rules on MREL (minimum requirement for own funds and eligible liabilities) and TLAC (total loss-absorbing capacity), which are good ideas for banks that are mainly financed in the market, but do not work as expected for banks essentially dependent on deposits. The latter are obliged to go to the markets and to issue debt with high costs that, in all likelihood, will be taken up by other banks, thus creating negative externalities for the stability and resilience of the financial system as a whole.

This is particularly worrying because it can undermine the construction and sustainability of the Banking Union.

4. Financeable risk and risk that is acceptable to society

Banks take risks as part of their normal activity. However, when such risks are excessive they can lead to huge losses – not only for banks and their investors, but for the whole economy.

Regulation plays a key role in reducing vulnerability and sources of risk and in containing the costs of financial instability when it arises. Nevertheless, it should be taken into account that the higher the capital required for the banking system, the higher the intermediation cost, decreasing the credit multiplier. A banking system with minimum risk means a banking system with maximum cost and, hence, smaller capacity to finance investment. If it is accepted that the financial system has to take some risk, regulations must lay down how society should react when risk becomes systemic, for instance, setting out the role of the different stakeholders in these cases.

Regulations should seek to make the financial system safer, but flexible enough to fulfil its function as a driver of economic development while being adaptable to new paradigms, namely to those resulting from technological innovation. Society's preferences in terms of financial security are not always consistent with the economy's financing needs or risks arising from innovation.

I will stop here, resisting the temptation to keep talking about these important and fascinating issues related to the regulatory and supervisory institutional frameworks in Europe. Let me just wish you a rich and fruitful debate and a very pleasant stay in Sintra.

Thank you for your attention.