Mugur Isărescu: Closing remarks - EUROFI High Level Seminar 2018

Closing remarks by Mr Mugur Isărescu, Governor of the National Bank of Romania, at the EUROFI High Level Seminar 2018, Bucharest, 27 April 2018.

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I am honored to be invited to give a few closing remarks at this EUROFI conference. EUROFI has turned, over the years, into a major European event that deals with financial issues.

The Great Recession compelled governments and central banks, regulators and supervisors of finance, to put into motion a radical reform of the ways financial industry does function. I do not wish to bother you with remarks that repeat what seems to have become a new conventional wisdom. However, it is never redundant to remember that oversize, too high leverage, unconstrained and reckless risk-taking, dangerous financial products, insufficient transparency, and, not least, poorly understood systemic risks, have forced the content and the pace of reforms. The European Institutions created a new regulatory framework after the eruption of the Crisis. The European Systemic risk Council (ESRB) represents the attention we all give to interconnectedness, to systemic risks that show up in financial markets. Not long ago, our widely embraced practices and thinking in central banking, in the regulation and supervision of finance, seemed like indestructible building blocks. The expansion of shadow banking, Fintech, non-conventional threats under the appearance of cyber-attacks, tail events in general, keep us vigilant and ask from us open-mindedness and constant reexamination of our beliefs.

There is much in the evolution of financial markets which provides puzzles; I am referring to the persistence of very low inflation in spite of large scale QEs, the flattening of the Philips Curve, the emergence of parallel currencies, etc. There is also a revival of attempts to control capital flows under the embodiment of macro-prudential means and a growing concern of central banks with financial stability. As a matter of fact, quite often, financial stability seems to have become the dominant goal of central banks in our turbulent times. Developments in the EU, which are pertinently reflected by the sessions of this EUROFI conference, indicate that, in spite of major progress achieved in redoing the regulation and supervision of finance, still much needs to be done. Some of the problems we do encounter are linked with the legacy of the Crisis and the years that preceded it.

It would be a shame if necessary reforms are not undertaken while there is a window of opportunity –as international financial organizations, European specialized bodies, including the ECB, emphatically argues. A slowdown is inevitable in time and it would be wise to have policy space at that time and more robust economies. But much depends on what governments do and whether they have the courage and social and the political support, apart from a critical mass of vision and well-articulated policies.

I do not wish to examine here issues related to reforms that go beyond the completion of the BU (Banking Union). But one thing is clear to me: unless the degree of diversity in the Euro area is smaller, unless economic divergence (that is illustrated by dynamics after the introduction of the euro) is reduced, further troubles will arise. Jacques de Larosiere, one of our doyens and a former president of EUROFI, never tires of pointing out this fact. Economic convergence is badly needed in the monetary union, where policy space for undertaking the correction of large external imbalances (deficits) is much diminished. I think that proposals made by the EC, by various governments, offer hope that better policies will be articulated in the not too distant future. Romania and other New Member States are bound (by the treaties of accession) to join the Euro area. And we care enormously that the Euro area, through its policy arrangements and tools, will enable economic convergence.

Coming from Romania, speaking today in Bulgaria, let me take this opportunity to share with you some of the challenges faced by non-euro Member States, in particular the ones in Central and Eastern Europe. Much has been said about growth and inflation in the euro-area, as well as about stage of the banking union. Less attention has been paid to Member States which want to join the banking union and the euro-area in the foreseeable future, but still need to implement structural reforms to get there. Their experience is relevant, nonetheless, for the Euro area Member States as well, as the common market and free movement of capital is a two-ways street.

Financial and business cycles in euro-area and non-euro area are not perfectly aligned. Growth is now much stronger in Eastern Europe, and the output gap has turned positive earlier than in the euro-area. Inflation has also reemerged in non-euro area. Some of it is cyclical, as it comes from international commodity prices, other supply side factors, but also from a strong domestic demand. Yet, some of it is structural, as any catching-up process is inflationary in nature. Higher wage growth pressure is normal, up to a point, in view of large wage differentials, migration flows, and labor market tightening. Despite the wage growth, CEE countries are becoming increasingly competitive, as productivity also grows. This is why the current account position of non-euro member states is better now than before the crisis.

The monetary policy normalization cycle runs also at a different pace. Even within CEE countries, while the monetary stance remains largely accommodative, the situation is quite heterogeneous regarding inflationary expectations, policy objectives, and policy tools used. As regards Romania, we started the tightening of monetary policy by hiking the rate twice this year, after further narrowing the corridor around the policy rate last year, but a gradual approach is warranted by the need to avoid sharp currency appreciation in the regional context.

In our case, the policy normalization has been supported by two favorable developments in the banking sector. First, the NPLs ratio dropped from 22% at end-2013 to 6.4% at end-2017, making it the largest adjustment in Europe over a relatively short time period. At the core of this adjustment were conservative requirements for provisioning NPLs, our hands-on supervision approach, and a fiscal facility that was conducive to the development of the secondary market for NPLs. Second, the share of local currency denominated loans in the total stock of loans has increased from one third prior to the crisis to two thirds nowadays. This reduced the contagion risk and improved the transmission mechanism of the monetary policy.

A somewhat higher inflation and an earlier start in the policy normalization cycle have to be considered in view of another challenge, which is the lower level of financial intermediation. Some countries are facing the dilemma recently portrayed in a Bruegel Institute paper, between raising inflation and decreasing appetite for risk, the latter being reflected in the lower levels of credit to GDP. The solutions adopted are diverse. While some central banks are embracing a higher inflation, and try to stimulate financial intermediation, others try to reign in inflationary expectations and have already started the tightening cycle. Nevertheless, the issue of financial intermediation remains important, as credit for the corporate sector would need to replace direct fiscal incentives in most of these economies as a driver of growth, if we want growth to remain sustainable.

The low financial intermediation in the banking sector comes, first of all, from the demand-side. Households' distribution of income and credit is more uneven in CEE than in euro-area; and corporate balance sheets have not been repaired to the same extent as the banks' balance sheets were. As for the alternatives on the supply-side, the capital market is thin, and the role of the other financial institutions is less important than that of banks – although there are some differences in country-level data.

This leads us to another challenge which has become increasingly important in non-euro Member States: the sovereign-bank nexus. Indeed, banks operating in non-euro area countries are more exposed to the domestic sovereign debt, as they hold a higher share of it. However, sovereign securities are the only highly liquid assets available in large amounts in small markets; hence banks have no realistic alternative to build liquidity buffers. Moreover, government debt levels in CEE are much lower than the euro-area average.

The contrast between high banks' exposures to sovereign debt and low government debt in non-euro countries emphasizes the structural challenges in these countries. Any solution for addressing the sovereign-banks nexus should account for the specificities of non-euro Member States, and in general of emerging countries not issuing debt in a reserve currency. In the spirit of European integration, any limit should be addressed to the banks' group level, not at the subsidiaries level – a solution which would help preventing fire sales and would not affect financial stability in these countries.

This takes me to the issue of integrated financial markets in Europe, not only in the euro-area. As Peter Praet mentioned in last year's Eurofi held in Malta, "private risk-sharing was the general principle of the new European rules such as the Bank Recovery and Resolution Directive (…) making banks equally liable across countries for the amount of risk they want to take into their respective balance sheet".

A pending issue for the completion of the Banking Union rests with the home-host approach in the resolution process. One of the main tasks within the resolution planning process for groups is to identify the most suitable resolution strategy and ensure its viability. Most of the resolution authorities and banking groups have embarked in a Single Point of Entry (SPE) resolution strategy at European level, acting according to their declared standing and European structure. The Single Point of Entry (SPE) resolution strategy is, by definition, the reflection of the idea of unity and cohesion, the purpose of the European Union.

When an MPE strategy is preferred, authorities must ensure the separability of the subsidiaries from the parent bank not only as a gone concern, but also as a going concern. If the local subsidiary does not act independently in its daily activities, it is unlikely that it will be able to do so in case of turmoil. According to European legislation, treasury functions, risk management and IT services are the most important areas of operational independence to be secured – and, therefore, they are at the heart of the home-host issue. This is particularly relevant for non-euro Members States from Central and Eastern Europe.

We agree that, at least until the conditions for an MPE strategy are met, the parent banks should continue to provide support for their subsidiaries. But how to do this it is a more delicate issue.

One way would be to transform subsidiaries into branches. Indeed, from an operational point of view the switch from subsidiaries to branches could bring some benefits. However, a higher burden will be placed on home countries' authorities, as these will have to take into account and protect financial systems and economies in the host countries. The home Deposit Guarantee Scheme (DGS) will be subject to a very high pressure in case the group fails and it must pay for the guaranteed deposits.

Although equal treatment and solidarity are desirable, the branches seem to escape the safety-net that has different patterns in each country. National legal frameworks for resolution and liquidation procedures would still be the main drivers in a failing situation, but these are limited.

An alternative solution for securing a de facto group financial support for the subsidiaries by using market instruments would relate to MREL (minimum requirement for own funds and eligible liabilities). If parent banks buy the local subsidiaries' eligible debt, this would represent a non-intrusive market solution for the problem of financial support, while observing the current resolution framework. Also, it would make central banks in CEE more likely to accept MPE (multiple point of entry) strategies in the future – as long as potential losses will be covered by parent banks.

The late Andrew Crockett, former General Manager of BIS, was one of the first to emphasize the important role of financial stability, distinct but complementary to price stability.

The aftermath of the recent global financial crisis has shown us that crisis management and resolution is also a public good, correlated with, but independent from, price and macro financial stability.

For financial integration in Europe to work, and for banking union to move forward, we should remember that there is one common market. The European legislation and the new proposals as well, which we broadly welcomed, do not refer to two asset classes of capital: inside and outside the banking union. Eventually, we will all be members of the banking union, and it is our joint responsibility to secure a level playing field.