Carlos da Silva Costa: Ten years after the 2008 financial crisis – where are we heading now?

Keynote address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the International Finance and Banking Society Conference 2018, Porto Business School, Porto, 30 June 2018.

* * *

[1]Good morning ladies and gentlemen,

It is a great pleasure to open this weekend's Conference, in which a wide variety of topics will be covered ranging from the more micro ones such as asset pricing to the broader issues related to financial stability and regulation.

In the spirit of the Conference's title and against the background of the post-crisis financial sector reforms, in my remarks this morning I will ask you to ponder where we are heading and what needs to be addressed to mitigate persisting financial stability risks in the context of an incomplete architecture of the European Union (EU).

The European project as you know is a political endeavour that has involved waves of integration over the last few decades. Each step determines the next, with the institutional set-up limited to what is required but without sufficient capacity to react to the unforeseen. In many cases the deepening of the integration process was motivated and steered through successive crises. Some may argue the crises were often existential.

Despite renewed calls in recent years for the completion of the European architecture, starting with the completion of the Banking Union, the outcome of yesterday's Euro Summit is a clear evidence of the hurdles we are facing. Do we need another crisis to steer further integration?

In advance of yesterday's Euro Summit, the Meseberg Declaration [2] and the ministerial agreement [3] between France and Germany was a welcome development as it was the first time in six years (since 2012) that concrete steps forward were proposed by elected politicians.

However, the Meseberg declaration and yesterday's Euro Summit, by falling short of delivering on further risk sharing while adding additional layers of risk reduction measures, lead us to consider whether the costs of attaining additional risk sharing are worth the risks to financial stability in the interim period. If not, what do we need to revisit and reassess to ensure it?

During the crisis, governments had to resort to bailouts when banks that had become too big, complex and interconnected were at risk of failure. Letting them fail would have meant that households and businesses would have been unable to access their money, finance their projects or make payments.

As highlighted by Tim Geithner, "by not imposing losses or 'haircuts' on non-deposit unsecured and secured claims on banks, by not bailing them in, [the US authorities] helped stabilise the financial system at much lower cost and recapitalised it largely with private, rather than public money." [4]

In the euro area, at the beginning of the crisis, the affected banks were mostly located in Germany, France and the Netherlands. In 2009, bank bailouts totalled around 8% of GDP in Germany, 5% in France and 12% in the Netherlands.[5]

In view of the growing discontent that followed, in order to reduce the risk of moral hazard and protect the taxpayer from shouldering private sector losses, there was a strong impetus against using public money in establishing a safety net for the financial system. Bail-in principles in resolving banks prevailed, and there was a general aversion to bailout provisions.

The post-crisis financial sector reforms were thus designed to strengthen financial stability by focusing on improving banks' resilience, ending too-big-to-fail, breaking the sovereign/bank loop and reducing financial fragmentation.

Efforts went into developing a harmonised regulatory framework, with stricter requirements on capital and (private) loss-absorbing capacity to protect taxpayers, while reinforcing risk prevention and reduction.

In this context, Basel III reforms [6] strengthened certain components:

- Enhancements to risk capture by revising areas of the risk-weighted capital framework that proved to be acutely miscalibrated, including the global standards for market risk, counterparty credit risk and securitisation;
- Introduction of macroprudential elements in the regulatory framework;
- Specification of a minimum leverage ratio requirement to constrain excess leverage in the banking system and complement the risk-weighted capital requirements;
- Introduction of an international framework to mitigate excessive liquidity risk and maturity transformation, through the Liquidity Coverage Ratio and Net Stable Funding Ratio.

In the EU, the Single Rulebook and the European System of Financial Supervision were introduced. The euro area went further, launching the first steps of the Banking Union and its institutions, the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) at an amazing speed.

The firm, cohesive European commitment towards Banking Union helped counter financial fragmentation. However, as the first two pillars of Banking Union were put in place, the political will to build the third pillar – a European Deposit Insurance Scheme (EDIS) – and complete the overall architecture waned as policymakers got stuck in the risk reduction vs. risk sharing debate, losing sight of the final objectives.

This lack of determination in completing Banking Union in accordance with the agreed timelines has seriously jeopardised its key benefits.

Today Banking Union means that supervisory and resolution decisions are mostly European, whilst the ultimate guarantor of financial stability remains national, with limited tools to act also in view of the existing rules for State aid from the European Commission.

This asymmetry could have had serious consequences in a series of recent cases, in which decisions were ultimately redirected to individual nations.

We need to ask ourselves what political landscape we would have today, had certain authorities not acted the way they did in order to preserve financial stability – the central objective of Banking Union.

Few things can be more destructive to citizens' trust in the European institutions than threats to financial stability, perceived as risking their savings. Such threats can have direct effects on citizens' frustration with European institutions and traditional political parties associated with them. Such frustration can push voters to support populist platforms and endanger the trust between Member States built over decades.[7]

The history of European integration should serve as a constant reminder of the consequences of the rise of extreme forms of nationalism. The rise of Euroscepticism that we have been witnessing across countries is a wake-up call for European leaders and authorities.

So, while those authorities were criticised for acting on their own to preserve financial stability, by acting the way they did, were they not ultimately complying with the spirit and safeguarding the future of Banking Union?

Can we also expect that authorities, which at the beginning of the crisis bailed out banks without in some cases even extending losses to junior creditors[8], would (re)act differently faced with similar risks?[9] Or do these authorities retain instruments that ensure financial stability is preserved? Should these be emulated?

As we stand, **in view of the existing mismatch between European oversight and national liability**, the objectives and interests of the several stakeholders involved are not aligned. With the benefit of six years of hindsight, **it is now clear that several links and stabilising elements are missing in the Banking Union.**

As the political will to move forward with the integration process is insufficient, **policymakers and co-legislators need to fine-tune the regulatory framework to preserve financial stability.**

I will now address some of the issues we have faced with the implementation of the post-crisis management framework.

In view of the absence of EDIS, if Banco Popular Español had actually failed, the Portuguese Deposit Guarantee Scheme would have had to reimburse depositors in the Portuguese subsidiary, even though the problems had not emerged in the Portuguese subsidiary and Portugal was neither supervising nor resolving Popular.[10]

As banks are to a large extent still "national in death", this example shows us that **we need to rethink the Single Point of Entry (SPE)/Multiple Point of Entry (MPE) resolution model in tandem with the strengthening of the supervisory powers of host national competent authorities (NCAs) and debate the contentious topic of ring-fencing measures.**

Additionally, a generalised entry into force of the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR), irrespective of the banks' business models, has meant that, as of today, many institutions would only be deemed resolvable if bail-in would be extended to the level of senior debt or even deposits.

This, in turn, can have destabilising effects, by amplifying the incentives for a bank run at the earliest sign of distress.

Although one may support and push for credit institutions to increase their loss absorption capacity, it is simply not reasonable to expect that compliance with Minimum Requirements for own funds and Eligible Liabilities (MREL) can be achieved by all credit institutions in the short to medium term without seriously aggravating their financing costs and profitability, while incentivising them to take higher risks.

Resolution authorities therefore need to be able to rely on alternative sources to support resolution actions, such as resolution funds, especially in the current period of transition during which loss-absorbing capacity is not yet available. However, the current internal loss absorption requirements (8% of total liabilities and own funds) and limitations on the amount of the resolution funds that can be used (5% of total liabilities and own funds) prevent this, by potentially subjecting senior debt and even unsecured deposits to risks incompatible with financial stability.

Moreover, the decision to establish a wider scope for **MREL** than for TLAC (Total Loss

Absorbing Capacity) cannot be ignored. Whereas TLAC applies only to G-SIBs (Global Systemically Important Banks), MREL applies to all credit institutions in the EU, regardless of their size.[11] **Proportionality and flexibility are thus crucial, in order to maintain the level playing field and avoid distortions in banking businesses.**

Regulatory-driven consolidation has thus become an imminent risk: if only larger banks are able to comply with increasingly complex regulation and potentially disproportionate requirements, we could be fostering the comeback of too-big-to-fail – which we were trying to avoid in the first place. In the context of Banking Union, consolidation is desirable but as a market-driven process resulting from advances in technology and the integration of markets.

As we stand, the approach adopted in the EU regarding MREL, combined with a set of other regulations, may challenge the sustainability of the business model of medium-sized institutions particularly those that are predominantly financed by capital and deposits. [12] The financing of small and medium-sized enterprises (SMEs), which are the core of the EU economy and job creation, may thus become harder – with the ensuing social and political consequences. This is a concrete threat stemming from the persisting risk reduction vs. risk sharing debate.

Ultimately, the incomplete set-up of the Banking Union and the full implementation of the resolution regime are a dangerous combination. One that calls for a **comprehensive rethinking of the existing framework of safety nets** [13] – especially when monetary and fiscal policy have limited room for manoeuvre.

The establishment of a fully-fledged EDIS continues to be very difficult politically, despite the fact that it is a necessary risk reduction instrument that reduces moral hazard [14], and should be recognised as such to build confidence and trust between Member States. Recent research by the ECB has shown that with proper risk-based contributions from banks, an almost negligible cross-border subsidisation occurs.[15] The fear that EDIS could imply significant transfers across countries in case of a new banking crisis is therefore unjustified.

Without EDIS we need to debate if there is the need and space for alternatives. Are (private) Institutional Protection Schemes desirable or do we need to consider other options?

Recent experiences have also put the topic of harmonising EU banks' liquidation regimes on the agenda of policymakers. **But what does bank liquidation mean? And do we have the tools to ensure that bank liquidations are orderly in the current context?**

Before jumping into the harmonisation of liquidation regimes, it must be acknowledged that this is not a silver bullet. Indeed, the considerable social and economic impact ensuing from the failure of a bank with systemic relevance at local level would remain.

It seems clear that the BRRD creates a comparative advantage for larger banks.[16] As recently stressed by Fernando Restoy, and experienced first-hand by Professor Panicos Demetriades during his tenure as Governor of the Central Bank of Cyprus, there is no clear room for a 'middle class' of institutions whose failure, and eventual liquidation, could be considered systemic but whose business model may be incompatible with the satisfaction of MREL requirements. Authorities thus need to be confident that the regular insolvency procedures could be applied to them without jeopardising financial stability.[17]

But how to accomplish that? Recent calls to form a sort of European FDIC (a version of the American Federal Deposit Insurance Corporation), merging the Single Resolution Fund (SRF) and EDIS into one single entity,[18] are welcome in this regard, provided that the legal framework is fixed and that financial stability – both at European level as well as at national level – is enshrined as the first and fundamental objective of any intervention.

However, as the political will to proceed with such a broad reform is currently non-existent, a question arises as regards countries' discretion on how to ensure financial stability. Whereas the public debate on harmonisation of liquidation regimes was motivated by perceived circumventions to the existing regulation, in view of the persisting risks, **should we not instead discuss alternatives to a further straightjacketing of nations' room for manoeuvre?**

Ben Bernanke's current research points to the fact that the financial panic of 2007–09 was the most dangerous part of the crisis. Bernanke is thus of the view that future work needs to take into account how severe the costs of financial instability are – in particular panics that lead to massive disintermediation.[19]

In the same spirit, in 2016 Tim Geithner noted, and I quote, "[i]n a panic, there will be no source of private funding or equity capital available at an economic cost or on a scale that can substitute for the resources of the State. You can choose to let the panic play out and allow the financial system to collapse and the economy to fall into depression. But if you want to avoid that outcome, you have to recognise that only the government has the ability to arrest a general panic, to offset the collapse in private demand, and to preserve the functioning of the credit system that is a necessary foundation for economic recovery." [20]

In this context, shouldn't we discuss the taboo of making use of public funds? We cannot forget that by limiting policy options on the usage of public funds, legislators and regulators may have ended up exacerbating risks in the event of a (systemic) crisis.

Against this background, should we not discuss:

- the application of the BRRD in its current form only to banks that are eligible for the European safety net?
- the revision of the BRRD and State aid requirements for medium-sized banks with systemic relevance where national authorities are willing to engage in the burden sharing without distorting competition?
- alternative ways to ensuring the exit of medium-sized and small-sized banks from the market while preserving value and protecting creditors and non-financial borrowers?
- special insolvency proceedings as an alternative to the 'atomistic' liquidation regime with a limited usage of public funds as a bridge to safeguard financial stability?

While the absorption of losses by private stakeholders should be the norm, flexibility should be preserved as the financial system's network structure plays a fundamental role in deciding whether there is the need for a government to intervene. [21] We should not forget that financial stability and public trust are in fact a public good.

To inform these discussions, a clear definition of what constitutes public interest and critical functions is required.

A comprehensive approach across legislation and stakeholders' interactions thoroughly analysing cross-implications is thus required to minimise moral hazard and vested interests while preserving the market discipline necessary.

Let me conclude.

Much has been achieved since the inception of the crisis ten years ago. Nevertheless, the foundations of the European architecture are still not sufficiently robust to withstand the impact of a future crisis. This should be the focus of policymakers and relevant institutions.

As the political will to steer further the integration progress is currently insufficient, it is urgent, and in the best interest of European citizens, that we revisit the existing rules now.

If it is not possible to complete the Banking Union as originally foreseen, we must structurally revisit the project to ensure that we have sufficient tools to safeguard financial stability when the next crisis hits.

Thank you for your attention.

---

1 As prepared for delivery.

2 www.bundesregierung.de/Content/EN/Pressemitteilungen/BPA/2018/20...

3 minefi.hosting.augure.com/Augure_Minefi/r/ContenuEnLigne/Downloa...

4 Geithner, T. (2016), "Are We Safer? The Case for Strengthening the Bagehot Arsenal", Per Jacobsson Lecture, IMF–World Bank Annual Meetings, 8 October.

5 Draghi, M. (2018), "Risk-reducing and risk-sharing in our Monetary Union",Speech at the European University Institute, Florence, 11 May.

6 Basel Committee on Banking Supervision (2017), "High-level summary of Basel III reforms", available at www.bis.org/bcbs/publ/d424_hlsummary.pdf.

7 Guiso, L., Herrera, H., Morelli, M. and Sonno, T. (2018), "Global Crises and Populism: the Role of Eurozone Institutions", CEPR Discussion Paper DP12944, 20 May.

8 Véron, N. (2018), "Bank crisis management and resolution: what is missing?" in "Towards a More Resilient Euro Area: Ideas from the 'Future Europe' forum", CEPS, and Véron, N. (2018), "EU financial services policy since 2007: crisis, responses and prospects", Global Policy Volume 9, Supplement 1, June 2018.

9 Klaus Regling recently noted that: "Germany should not forget that its banks received more public money during the financial crisis than almost any other European banking system – with the exception of Spain and Ireland. Taxpayers had to shoulder high losses. It is wrong to assume that German banks would never need any money", Interview published in Süddeutsche Zeitung, 25 June 2018.

10 Nouy, D. (2017), "Banking union, three years on – has it lived up to its promises?", statement at the Single Resolution Board Conference, Brussels: "Banks are supervised and resolved at European level, but in the event of a failure, the negative consequences are felt mainly at national level. (…) If, for instance, the Spanish Banco Popular had actually failed, Portugal's deposit insurance scheme would have had to refund depositors in the Portuguese subsidiary. That is a consequence of having supervision and resolution at European level. The Portuguese authorities would not have been involved in either process."

11 Restoy, F. (2018), "Bail-in in the new bank resolution framework: is there an issue with the middle class?", speech at the IADI-ERC International Conference "Resolution and deposit guarantee schemes in Europe: incomplete processes and uncertain outcomes", Naples, 23 March.

12 Restoy, F. (2018), op. cit.

13 Geithner, T. (2016), op. cit.

14 Smaghi, B. (2018), Financial Times Op-Ed "European banking union needs its final leg", 21 October 2017.

15 Carmassi, J., Dobkowitz, S., Evrard, J., Parisi, L., Silva, A., Wedow, M. (2018), "Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?", ECB Occasional Paper 208, April.

16 Demetriades, P. (2017), "A Diary of the Euro Crisis in Cyprus: Lessons for Bank Recovery and Resolution", Palgrave Macmilan: Cham Switzerland.

17 Restoy, F. (2018), op. cit.

[18] Constâncio, V. (2018), "Completing the Odyssean journey of the European monetary union", remarks at the ECB Colloquium on "The Future of Central Banking", Frankfurt am Main 16–17 May. In fact, the establishment of Banking Union was inspired by the American FDIC. However, it fell short of providing the SRF or EDIS with the right instruments and means to guarantee financial stability.

[19] Bernanke, B. (2018), "The real effects of disrupted credit: evidence from the global financial crisis", Per Jacobsson Lecture, BIS Annual General Meeting, Basel, 24 June.

[20] Geithner, T. (2016), op. cit.

[21] Bernard, B., Capponi, A, and Stiglitz, J. (2017), "Bail-ins and bailouts: Incentives, connectivity, and systemic stability", VoxEU.org, 18 October.