DeNederlandscheBank

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“Rethinking financial stability; Evaluating regulatory prime concerns a decade on from the financial crisis”

Speech by Klaas Knot, at the Global Risk Regulation Summit, Risk Minds International
Amsterdam, 3 December 2018

At the Risk Minds International Conference, 3 December, Klaas Knot reflects on the developments since the onset of the financial crisis in 2008. The implementation of the financial reform agenda is advancing and the European banking sector is in safer waters. Looking forward Knot recognizes three elements of focus: completing implementation & evaluating reforms; improving the business model sustainability and market confidence in European banks; and being alert to the buildup of leverage outside the banking sector. Knot concludes that the financial industry is continuously evolving, and financial regulation will have to follow suit.

Good morning, and also on behalf of the Dutch Central Bank welcome to Amsterdam!
December is the time of year to reflect and the time of year to look ahead. 2018 was a special year, as it marks the tenth anniversary of the onset of the global financial crisis. Many times I have heard: "ten years since the start of the crisis". But so far I have never heard anyone frame it in a more positive way: "It is the tenth year without a new global financial crisis materializing!" But maybe that is only natural, as central bankers and supervisors would never celebrate a crisis that did not happen.

Looking back to the situation ten years ago, we were in the midst of immense financial chaos. Many factors contributed to the crisis, I will not go into them, but years of deregulation and resulting gaps in regulation were definitely part of the story.

What I will do today, is to try to shed light on the prime regulatory concerns we have right now, divided into three main areas: First, I would like to reflect on the financial reform agenda that has been carried out. My message there will be that we have made good progress but we still have work to do.We need to consolidate, implement and evaluate.

Second, I will argue that the European banking sector has to move from safety to soundness, with the key take away being that we should promote further integration and improve efficiency.

And third, I will outline my view on financial stability going forward. Financial stability being a concept that evolves over time and should incorporate new developments and risks.

1. The financial reform agenda
So first let us look at the reforms carried out in the aftermath of the global financial crisis, which prompted a fundamental rethink of financial stability. In the landmark April 2009 summit in London, G20 leaders pledged to do whatever was necessary to rebuild trust[1]. Subsequently, supervisors and regulators worldwide, under the leadership of the Financial Stability Board worked to repair the financial system and strengthen financial regulation. This included bringing systemically significant institutions such as hedge funds under supervision. They also pledged to increase the requirements for regulated financial institutions.

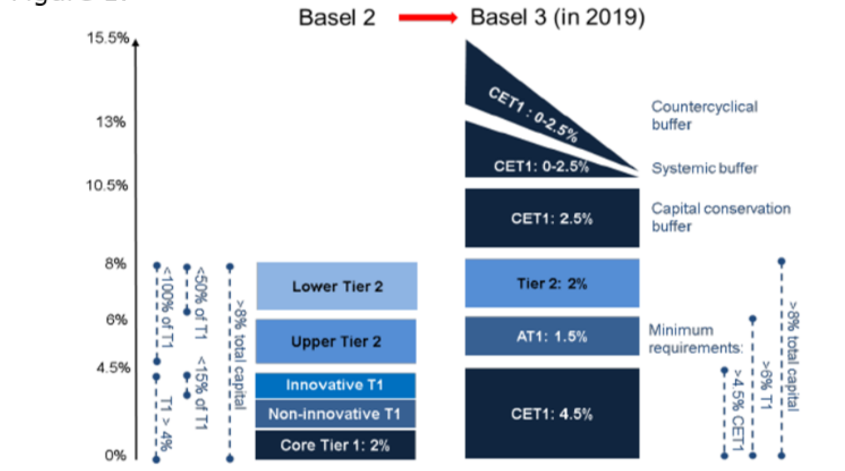
Within a relatively short time frame, the foundations for reform were laid. These concerned Too-Big-To-Fail (TBTF), the OTC markets, CCPs and the insurance sector. And most importantly with respect to the banks at the core of the financial system: the Basel III agreements. The implementation of this financial reform agenda is advancing[2]. Initially the focus was mostly on the banks, and this has led to at least four positive developments.

First of all, the Basel III reforms increased both the quantity and the quality of capital that banks must hold.

[1] G20 London Summit – Leaders' Statement – 2 april 2009
[2] FSB (2018): http://www.fsb.org/wp-content/uploads/P281118-1.pdf

Improved quantity and quality of capital

Figure 1.

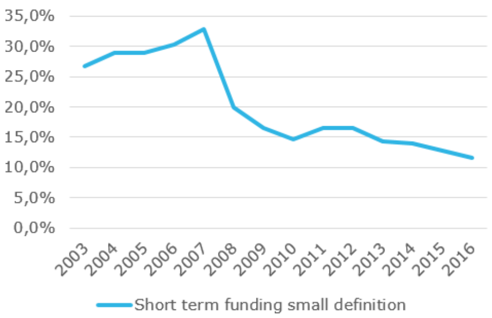


Source: Citi Research

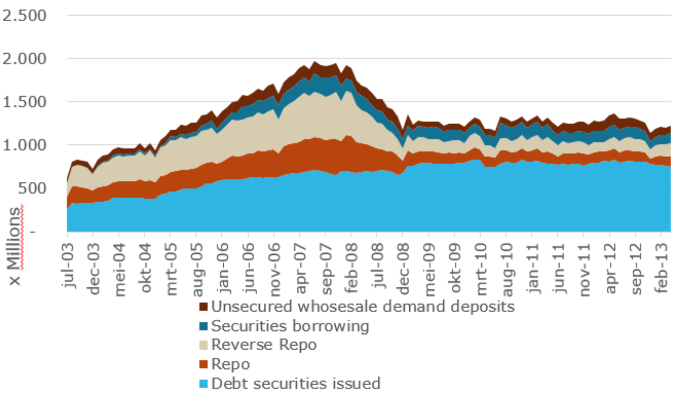
Before the crisis banks could get away with as little as 2% Common Equity Tier 1 capital. As the figure[3] shows, the Basel III reforms changed the composition of the capital requirement, by increasing the share of CET1. In addition CET1 has been strictly defined, increasing the quality of capital. Plus we put more emphasis on stress testing and pillar 2, and introduced macro-prudential buffers. For the first time we also introduced global liquidity requirements.

NL banks reduced reliance on short term funding

Graph 1. Short term funding



Graph 2. funding composition Dutch banks



Source: DNB

Before the crisis banks became overly reliant on short term funding. The introduction of the Liquidity Coverage Ratio, which is one of the global liquidity requirements, reduced this increased reliance on short term funding again. The graphs illustrate this development over time for Dutch banks.

The left-hand graph looks at all funding that needs to be repaid within the next 30 days excluding open-maturity items, such as retail deposits.[4] The graph on the right side confirms this trend. Debt securities can be considered long-term wholesale funding. The decline in the share of repos and reverse repos compared to other sources of wholesale funding illustrates the increased tendency towards more long-term funding.

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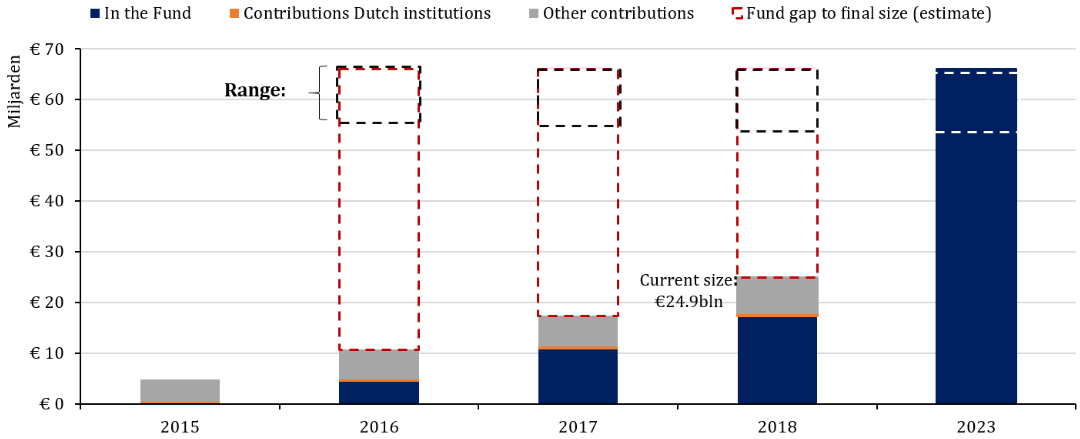
[3] Figure from Citi Research, retrieved via Valuewalk.com (2013), "*Basel III Will Create New $1 Trillion Hybrid Debt Market*", accessed in November 2018.
[4] The graph looks at the duration of funding. The line '*Short term funding small definition*' is the funding to be repaid within the next 30 days excluding open-maturity items, e.g. retail deposits. Sample consists of Dutch banks only.

Secondly, a greater focus was introduced on cross-border activities and consequently cross-border supervision. In Europe we even went a step further and introduced joint supervision via the Single Supervisory Mechanism. This strongly increased EU cooperation and harmonization, and improved the quality of supervision of all EU banks.

The third improvement was the creation of a resolution regime.

Single resolution fund is filling up

Graph 3. SRF



The resolution framework is implemented in EU legislation and the Single Resolution Fund is being built up. It is approaching the halfway mark and within the next five years we should be able to reach the target level[5].

And, finally, supervision is also becoming more forward-looking. This includes, for instance, looking at the kind of corporate culture and conduct that has proven to be able to result in financial troubles further down the road. In the Netherlands we were among the frontrunners here.

This is not an easy issue to address, but it is gaining traction internationally, as demonstrated by the Irish Tracker Mortgage Examination[6] and the Australian parliamentary Review of the four major banks[7]. This approach is now also an element of the SSM toolkit.

The list of improvements is impressive, and worthwhile to consolidate. Acknowledging nonetheless that the implementation of the reform agenda is not yet complete, I want to draw your attention to two challenges.

The first challenge is confronting regulatory fatigue, and not forgetting the lessons of the crisis. Although the crisis broke out only ten years ago, its memories begin to fade and in some corners of the industry a renewed push for deregulation can be heard. Also we ourselves on the public side have been working on developing and implementing the reform agenda for close to ten years now. While tremendous progress has been made, the pace of implementation is not equally convincing everywhere.

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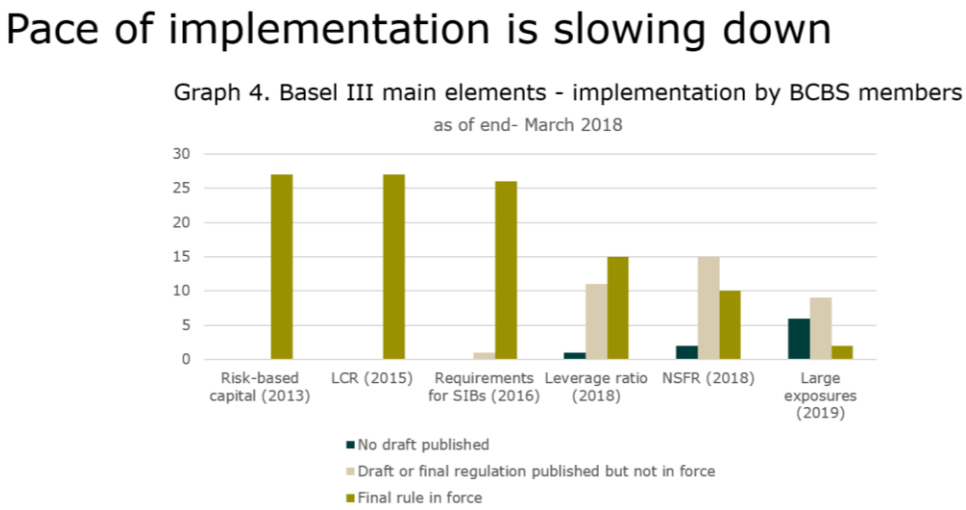
[5] The exact target level of the SRF depends on banks' covered deposit volume.
[6] Irish Central Bank (2018) Mortgage Tracker Examination
[7] Australian Standing Committee on Economics Review of Australia's Four Major Banks,



Source: BIS (2018) "*Fifteenth progress report on adoption of the Basel regulatory framework*"

For example, on the reform agenda for banks, the Basel Committee noted in October 2018 that several member jurisdictions are behind schedule in implementing the leverage ratio, NSFR and large exposure framework. This also hits close to home, as the EU is still working on the implementation of these last three standards.

Good news is that the finalization of the European capital requirements legislation (CRR2) is drawing to a close. This gives Europe much needed time to focus on the final part of the reform agenda for banks: implementation of the most recent refinements of Basel III, which should be implemented by 2022. As I also recently argued at the PetersonInstitute[8]: the current accommodative monetary policy environment makes it even more important to fully implement standards and strengthen prudential buffers.

The second challenge is withstanding the call for dilution. Across the globe I observe a tendency to dilute standards. This tendency presents itself on different fronts. Examples include relaxation of credit origination standards, application of preferential risk-weights, exemptions to the leverage ratio requirement, and tweaks in the definition of systemically important financial institutions.

The list of examples is by no means exhaustive. And for all these modifications a certain public policy rationale can be given: stimulating socially desirable lending, fostering financial integration, or whatever. They however come at the expense of reduced loss absorbency in the global banking system.

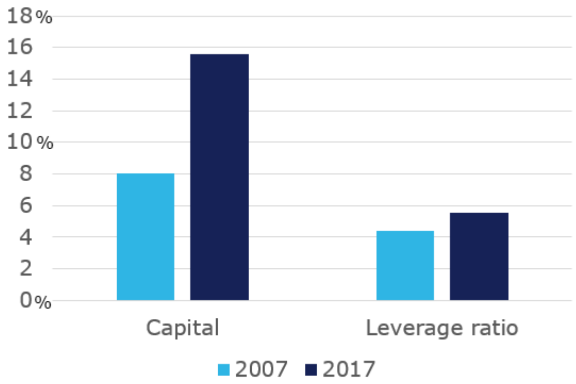
When designing and implementing such a major reform agenda it is inevitable that new distortions enter the system. It is therefore imperative that targeted policy evaluations are also undertaken. Such evaluations should not only focus on whether existing distortions have been sufficiently mitigated, but also whether unintended side-effects have come to the fore. Needless to say, such evaluations should be evidence- rather than sentiment-based.

2. From safety to soundness for banks: the status of the European banking sector
So while implementation is proceeding, we could say that we're not there yet. But it has already left its mark on the banking sector, which is in the midst of an adjustment process. Zooming in at the European banking sector, we see that in many respects the situation is better than ten years ago.

[8] Knot, K. (2018), "*Speech Klaas Knot Easy Money – Uneasy Finance*", given at Peterson Institute for International Economics, Washington, published on the DNB website

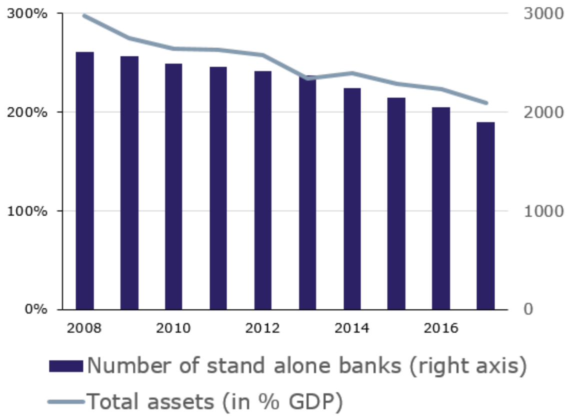
Situation European banking improved

Graph 5. More solid banks



Source: ECB Datawarehouse

Graph 6. Less banks and banking

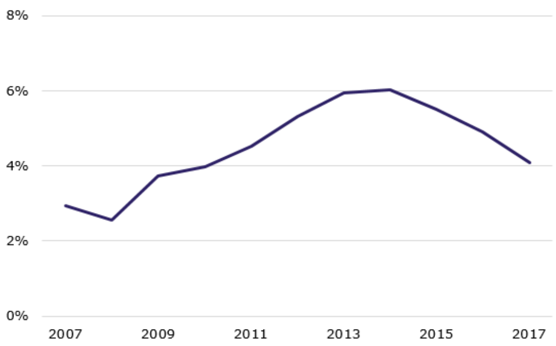


Capital was strengthened, leverage ratios improved, and at least some consolidation took place. We are in safer waters, as the results of the EU-wide stress tests about a month ago have illustrated. I understand that you will hear more about this later today. And we need these safer waters, as the banking sector does have plenty of challenges ahead of it.

For starters, price-to-book values of European banks continue to be low, at 0.7 on average in the euro area last year, compared to 1.3 in the US.[9]
Some will argue that this is the result of capital requirements being too stringent. Obviously, I do not agree. The US experience demonstrates that strong requirements and sound business models and valuation can and must go together. But the European banking sector still suffers from structural problems which cause low valuations and low profitability.

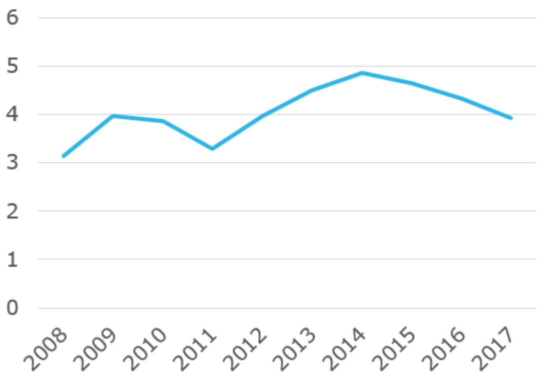
NPL and sovereign-bank nexus still problematic

Graph 7. NPL European banks as % of total loans



Source: ECB Datawarehouse

Graph 8. European banks holdings of sovereign debt (% total assets)



One important legacy issue is the high level of non-performing loans. The level is declining, but aggregated data mask the fact that there are substantial differences between countries and between individual banks. Moreover, Europe is still overbanked and the banking sector is fragmented.

The efficiency of the European banking sector needs improving. Consolidation can help, especially where there are many small-sized banks. In a well-integrated European market it can also be expected

[9] BIS (2018), "*BIS Quarterly Review - March 2018*", p.84.

that more pan-European players will emerge. The conditions for this to happen have already improved, in particular with the creation of the SSM. We do see banks expanding their activities in other EU countries.

Cross-border mergers would be another possibility. Whether there is a good economic business case for a pan-European merger is up to the market players themselves. We should however acknowledge that theoretical economic benefits of mergers may not always be attainable. History has shown that there tends to be excessive optimism in takeover deals.

In the Netherlands we have had some unfortunate experience with ABN-AMRO in 2007 and 2008 – this kind of crisis does not bear repeating! Also, more complex institutions are more difficult to manage, not to mention the difficult task of integrating IT systems.

From my perspective, financial stability considerations need to be taken into account as well. A cross-border merger may increase contagion risk, as financial sectors become more interconnected. After having addressed Too-Big-To-Fail problems at the national level, we would not want the problem to resurface at the European level. Banks could well become more difficult to resolve, as mergers typically make them larger and more complex.

Of course the system has been strengthened to meet such concerns. But it has yet to be proven that this has eliminated Too-Big-To-Fail problems. Financial stability and resolvability must therefore play a prominent role in assessing any merger, including cross-border ones. Resolution plans will have to be credible, deposits must be safeguarded, and minimum requirements for own funds and eligible liabilities have to be met, so there is enough loss absorbing capacity.

I think it was Mervyn King or Charles Goodhart who once said that banks are global in life but national in death. In Europe, we have tried to address this contradiction by establishing both the Single Supervisory Mechanism and Single Resolution Mechanism.To arrive at truly European burden sharing, we need a fiscal backstop to the Single Resolution Mechanism, and a European Deposit Insurance Scheme to complete the banking union. Removal of the remaining obstacles involves more ambitious efforts to handle the problems of non-performing loans and addressing the sovereign-bank nexus.

Once we succeed in delivering both safety and soundness, the lower risk of failure will lead the cost of equity to go down. After all, risk and return are two sides of the same coin. Before the crisis, underpricing of risk led to excessive risk-taking.

With better, safer and sounder banks, risks will be more correctly priced, and structurally lower rates of return on equity can be welcomed from a financial stability perspective.[10]

3. Financial stability going forward

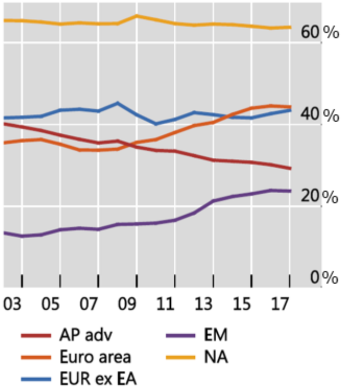
In the first part of my speech I concluded that substantial progress has been made in implementing the agreed post-crisis reforms. Subsequently, I noted that the European banking sector is still on its way from safety to soundness. But we also have to look beyond banking. Risks are migrating, and new risks are emerging.

The financial system is evolving and becoming more diverse. Financial stability should incorporate such developments and, where appropriate, regulation should also catch up. The diversity of the financial system presents challenges from a regulatory and financial stability perspective. Tightening micro- and macroprudential policies on the banking system has inevitably lead to an increase in non-bank lending – the so-called 'waterbed effect'[11].

[10] DNB (2016), "*The return on equity of large Dutch banks*", Occasional Study nr. 5.
[11] For evidence, see Cizel et al (2016), "Effective macroprudnetial policy: cross-sector substitution effects of price and quantity measures," IMF working paper.

Non-bank financing to private non-financials grows

Graph 9. Non-bank financing to private non-financials



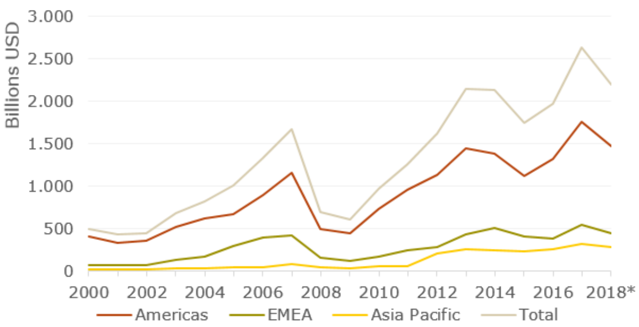
Source: FSB (2018) "*Implementation and Effects of the G20 Financial Regulatory Reforms: Fourth Annual Report*"

In particular in the euro area we observed a relative increase in finance by non-banks. At modest degrees of leverage, non-bank lending can be a useful complement to bank lending and reduce the concentration in funding sources. More equity based financing would also increase loss absorbing capacity.

Problems however arise if there is too much liquidity transformation and/or too much leverage. In this situation non-banks can become major source of instability. The leveraged loans and high yield bond markets are particularly vulnerable in this respect.

Leveraged finance market vulnerable to instability among non-banks

Graph 10. Leveraged finance



Source: DNB & Dealogic (2018)

High yield debt levels are well above pre-crisis levels in the US, and roughly at pre-crisis levels in Europe.[12] The good news is that the direct exposure of European banks seems relatively limited. The bad news is that non-bank financial intermediaries provide a high and increasing share of financing in the high-yield debt market[13].

Should conditions deteriorate, such non-bank financial intermediaries are directly exposed to considerable potential losses. Increases in credit risk premia would add to that. And perhaps even more important, there could be system-wide spillovers beyond the high-yield debt markets.

In the past decade we focused most of our attention on strengthening bank regulation. This was much needed, and on this front much has also been achieved. Now we observe emerging risks within non-

[12] FSB (2017), "*Global Shadow Banking Monitoring Report 2016*", Annex 7 p.87.
[13] Calculations based on Bloomberg data.

bank entities. Regulation of non-bank entities may help to ensure that liquidity and credit risks in all parts of the financial system are well-managed.

But if we conclude that from a financial stability perspective excessive debt and leverage of non-financial counterparts are actually the main drivers of risk, we could also look for instruments that aim to address these directly, such as borrower-based regulation.

The Dutch consumer mortgage market is a case in point here, where we have set limits to both the loan-to-value and loan-to-income ratios that apply to all lenders, banks and non-banks alike. Such an approach could be explored more broadly.

5. Conclusion

Ladies and Gentlemen, I want to conclude. After the global financial crisis banking regulation has been significantly strengthened. Efforts should now focus on consolidation, implementation, and evaluation of the reform agenda. The banking sector is in safer waters now. But European banks need to do more to make their business models sustainable and regain market confidence. At the same time we have to be alert to the buildup of leverage outside the banking sector.

The financial industry is continuously evolving, and financial regulation will have to follow suit.