Ed Sibley: Monetary and financial stability - the implications for prudential supervision

Speech by Mr Ed Sibley, Deputy Governor (Prudential Regulation) of the Central Bank of Ireland, at the 46th OeNB Economics Conference "European Economic and Monetary Union: the first and the next 20 years", in cooperation with SUERF, Vienna, 2 May 2019.

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Introduction

Good afternoon, it is a pleasure to speak to you today.

The theme of the conference 'European Economic and Monetary Union: the first and the next 20 years' gives us wide scope to share some of our thoughts. We have much to learn from the last twenty years.

If we look back to 2007, problems had started to crystallise and accelerated in 2008, particularly post Lehmans, as market participants retreated towards safe assets. This tendency was intensified by the complexity and lack of transparency in the financial system. In other words, due to the complexity of the market, participants could not establish with confidence which risks would end up with whom and how they might be exposed to the ultimate holder of certain types of risks. Consequently, the market moved away from many higher risks. This included Irish banks with their large property exposures. The move away from the higher risks due to concerns about solvency took the form of a withdrawal of short-term liquidity, leading to the failure of the Irish banks and many others.

The crisis exposed a long list of contributing factors including:[1]

- Underestimation of the riskiness of securities created with financial engineering;
- Misaligned incentives;
- Excessive funding of long term assets with short-term liabilities;
- Ratings agencies failures;
- Flawed assumptions regarding house prices;
- Elevated household debt;
- A belief by bankers that their institutions were too big to fail;
- Global imbalances;
- Appropriate accounting of financial assets;
- Excessively loose monetary policy;
- Inadequate or flawed micro and macropudential regulation; and
- Deep flaws in supervision.

The crisis also highlighted the fundamental importance of financial stability to protecting consumers and investors and that it is a collective responsibility to safeguard financial stability. Of the financial firms themselves, of regulators and supervisors of all segments of the financial sector, of central banks, of macroprudential authorities, of resolution authorities, and indeed of governments to ensure the right legislative and institutional frameworks and incentives exist for a stable financial system.

And the architecture of Banking Union has been built to reflect this collective responsibility.

The global monetary policy response since 2008, for example, has dampened volatility and addressed system-wide liquidity concerns.

The continued monetary accommodation has – in addition to incentivising banks to lend – afforded banks the time and space to build buffers, repair their balance sheets and deal with legacy issues.

In his remarks, Andreas mentioned the interaction of monetary policy and macroprudential policy.

I will pick up the baton there.

I will conclude by giving my thoughts on Banking Union. But in the first part of my remarks today I will endeavor to address how new measures to address financial stability have changed how we supervise banks and discuss how in turn, our supervision promotes and contributes to safeguarding financial stability.

The Central Bank of Ireland has a wider and more diverse mandate than most Central Banks. We are including the National Central Bank, National Competent Authority for credit institutions, investment firms, funds and insurance firms, National Macroprudential Authority, National Resolution Authority and have important roles in conduct, consumer protection and Anti-Money Laundering (AML).

Given this wide mandate and relatively large financial sector in Ireland, we therefore must consider financial stability in a holistic fashion across different segments of the financial sector. Moreover, given the nature of financial services operating in Ireland, we necessarily must take a wider European and global view. We concern ourselves, directly and through our work in the regulatory and supervisory ecosystem, with the functioning of the financial system with the aim of ensuring that it is serving the needs of the economy, consumers and investors.

My key message today is a comprehensive approach to financial stability is needed – not just at national level, but also at a European level. Not just for banks, but also other segments of the financial system. This will require closer coordination, more information sharing and deeper embedding of macro-financial analysis and policy into prudential supervision. More also needs to be done in Europe with respect to resolution, deposit insurance, capital markets union and the cultures within financial institutions. I will return to this towards the end of my remarks. Lastly, the effect of the "regulatory pendulum" has been a feature of financial booms and busts. It is important then that we do not let memories fade. We must recognise the important role of strong regulatory and supervisory frameworks in delivering a resilient and stable financial system.[2]

Macroprudential policy, financial stability, and prudential supervision

To promote financial stability, macroprudential policy aims to strengthen the resilience of the financial system so that it can withstand adverse movements in credit and property prices, and other macroeconomic shocks.

Policy measures are forward-looking and seek to reduce the potential for imbalances to accumulate, given that they could lead to financial distress.

Intermediate objectives are:

- To prevent excessive credit growth and leverage;
- To prevent excessive maturity mismatch and market illiquidity;
- To limit direct and indirect exposure concentration; and
- To reduce the potential for systemically important banks to adopt destabilising strategies and to mitigate the impact of such actions.[3]

These are also of fundamental concern for microprudential supervisors – we just look at it from an individual institutional perspective.

In the main, supervisors are involved in National Macroprudential Authorities.[4] But the advent of macroprudential policy has also coincided with a change in banking supervision.

Macroeconomic assessments

First, macroeconomic assessments have become a fundamental component of microprudential supervision. Stress testing, for example, is now a key tool of supervisors with the recent EU-wide banking sector stress test showing the variety of macroeconomic variables considered including GDP, inflation, unemployment, asset prices and interest rates.[5] Stress tests involve macro considerations in identifying risks and setting out a plausible scenario while the results showing how banks are affected are a key input into setting individual bank capital requirements.

Business model analysis also takes macro-financial factors into account when assessing risks faced by banks. Last year, for example, ECB Banking Supervision published a thematic review on profitability and business models, which highlighted that low profitability and pressure on revenues from the economic environment, among other factors, affect the European banking sector.[6] The findings from the thematic review feed into the Supervisory Review and Evaluation Process (SREP).

Capital requirements

Second, broadly speaking, capital levels have increased markedly in Europe over the past decade. At the end of 2009, the average Tier 1 capital ratio stood at 10.2 per cent while at end-2018, this had improved to 16.3 per cent.[7] Today, capital requirements of banks are decided by different authorities and institutions.[8]

This reflects the various elements that need to be taken into account when assessing bank capital requirements.

Different macroeconomic and financial cycles, different structures of economies and different structures of financial systems, among other factors, justify different capital requirements. Banking union does not render these differences inconsequential – just as single supervision does not mean that every institution has the same capital requirements, banking union does not mean that every banking system has the same level of capital requirements.

Thus, capital requirements are determined through decisions taken by microprudential supervisors with respect to pillar I and pillar II requirements, but also through the polices implemented by macroprudential authorities with respect to the Other Systemically Important Institutions (O-SII) buffer and the countercyclical capital buffer (CCyB), for example. Another aspect of banks' capital requirements that is relevant is the Minimum Requirement for own funds and Eligible Liabilities (MREL), which is decided upon by resolution authorities.

Supervisors must therefore cooperate and coordinate effectively with macroprudential authorities and resolution authorities – whilst respecting their differing mandates – to ensure the resilience and stability of the banking system.

Borrower based measures

Third, borrower based measures such as loan-to-income limits (LTI) and loan-to-value limits (LTV) make both banks and borrowers more resilient.

Increased Co-ordination

Wider institutional fora are important when thinking about the joint responsibility 'authorities' have for financial stability. These vary in composition and mandate at national level.[9]

At European level, the ESRB was established in 2010 to oversee the financial system of the European Union (EU) and prevent and mitigate systemic risk. It is an important forum which brings together representatives of EU institutions, Governors of National Central Banks, and high level representatives of the National Competent Authorities.[10]

For the euro area, the Macroprudential Forum is composed of the Governing Council and the Supervisory Board of the ECB and it is a platform for regular, high-level discussions, bringing together microprudential and macroprudential perspectives from across Europe.[11]

The advent of macroprudential policy has therefore coincided with and reinforced an important change in thinking about microprudential supervision. This is embedded in our framework for supervision and our tools for stress testing.

Effective cooperation and coordination given the multi-level and joint responsibility is critical to preserve financial stability.

Resolution, financial stability and prudential supervision

The establishment of national resolution authorities and the Single Resolution Board has been an important institutional development since the crisis. However, the introduction of the Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism (SRM) goes well beyond this, and has also had a wider impact on how we supervise banks.

The BRRD was introduced to provide authorities with a regulatory toolkit to manage bank failure, with the objectives of ensuring the continuity of critical economic functions, minimising the impact on the economy and financial system, avoiding the destabilisation of financial markets and limiting the cost to taxpayers.

Resolution is therefore fundamentally a financial stability issue.

The BRRD has also importantly changed how we supervise banks.

Resolution authorities have the primary responsibility for resolution planning and execution. Nonetheless, supervisors should be actively considering the resolvability of a firm, alongside financial resources (for example, supervisors review institutions' internal capital and liquidity adequacy assessment processes), business model sustainability and governance, culture and risk management. Ultimately, whether a firm can be resolved should be reflected in our supervisory risk appetite.

The supervisor is consulted on resolution plans, prepared by resolution authorities, which gives us a deeper knowledge on legal structure, critical functions, internal and external interdependencies (i.e. essential services etc), IT systems, access to financial market infrastructures, preferred resolution strategies, and separability to name just some of the contents. Moreover, supervisors should be actively working with resolution authorities to address impediments to resolvability. This is not without its challenges, but if a bank is only surviving because it is not resolvable, it is not viable, and requires appropriate supervisory intervention

Supervisors now also review recovery plans, prepared by banks which map out what they will do if they get into difficulty.

- We now assess detailed recovery options, scope and timelines for action for each bank.[12]
- We have financial impact assessments and feasibility assessments which include financial, operational, reputational, legal and business model risks, as well as a consideration of a

much wider range of factors.

- Plans are required to include the assumptions underlying effects, governance and implementation, impact on critical shared services, critical functions and core business lines, impact on stakeholders and systemic consequences, communications plans, and preparatory measures.

Last year, ECB Banking Supervision undertook a review of recovery plans to learn from best practice and experience to help further shape operational success of plans going forward.

Whilst much has been achieved, there is still considerable room for improvement in terms of feasibility, credibility and options for recovery.

This new EU recovery and resolution framework is not a panacea. It remains a work in progress. But important work in progress.

Much work therefore remains to be done to ensure financial stability going forward.

The measures introduced to date however, have already changed how we supervisors think about risk and risk mitigation.

Non-bank financial intermediation, financial stability and prudential supervision

To maintain financial stability, we cannot solely focus on banks.

Non-bank finance has become an increasingly important source of financing of economic activity. Since the crisis in 2008, globally (as reported by the Financial Stability Board (FSB)), banks' share of total global financial assets has declined from 45% to 39%, as so-called 'OFIs' or other financial intermediaries take larger shares (from 26% to 31%).[13]

This evolution can bring with it different types of systemic risk which can threaten financial stability, be they via direct exposures or indirect exposures – for example when common assets are held or move together.

Just one salient example of this is Commercial Real Estate (CRE).

- The size, interconnectedness and use of high leverage makes CRE important for financial stability, and hence important for supervisors. This is particularly important in today's monetary policy environment with low interest rates and search for yield dynamics which are increasingly pushing up prices.[14]
- On the one hand, the fact that CRE financing is moving outside domestic banking systems is positive for financial stability – potential losses can be shared more widely, liquidity is increased and foreign investors may exit an overheating market sooner, thereby dampening a boom.[15]
- On the other hand, given growing interconnectedness boom-bust cycles could be amplified as CRE markets become more synchronised globally. Authorities need to be ever more vigilant in monitoring leverage and maturity mismatches of non-bank entities.
- Forthcoming research by staff at the Central Bank of Ireland highlights these risks and vulnerabilities and that shocks to market-based finance can be a source of disruption of services to the real economy in and of itself.[16]

What does this mean for supervision?

- It means all sectoral supervisors must have a wider view of the financial system in which firms are operating.
- It means supervisors must increasingly focus on macro-financial dynamics.

- It means financial stability assessments must be fully embedded in supervisory risks frameworks.
- It means that where National Competent Authorities for banking are separate from funds or insurance for example, they must cooperate more intensively.

This is not easy to achieve.

However to maintain financial stability we must take a holistic perspective and pursue an integrated approach. This is important to ensure that the entire financial system serves the best interests of consumers and wider society.

Banking Union and CMU

So where does this leave us?

Much progress has been made to increase financial stability in the EU and euro area, initially with the establishment of the European System of Financial Supervision encompassing the European Supervisory Authorities and the ESRB, and then with the establishment of the Banking Union – notably with the establishment of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism.

The first 20 years of EMU have been chequered; the culmination of a 30-year upswing in the global financial cycle, and the worst economic crisis since the 30's.[17]

The crisis resulted in many important legislative and institutional innovations, with the introduction of the SSM and SRM being the most visible.

However, the job is not yet complete.

To list a few areas of priority:

- Significant work is required in the banking sector to ensure adequate risk reduction in the level of non-performing loans and a build-up of MREL.
- The issue of liquidity in resolution will need to be addressed within Banking Union to ensure there is a lender of last resort to provide liquidity support if and when required.
- More is needed to ensure that banks are resolvable without recourse to the taxpayer.
- Therefore, the second pillar of banking union remains incomplete.
- The third pillar of the banking union – a European deposit insurance scheme (EDIS) – remains missing. Deposit protection should transfer to the European level, as has already happened with banking supervision and bank resolution.
- Completing Capital Markets Union (CMU) should also be a priority. Deep and liquid capital markets have the potential for private risk-sharing to smooth economic shocks, thus increasing stability.

So, much has changed for prudential supervision in response to the measures enacted to preserve financial stability going forward.

And what does the next twenty years have in store?

Well, a lot of work: from regulators and supervisors of all segments of the financial sector, from central banks, from macroprudential authorities, from resolution authorities, and indeed from governments to ensure the right legislative and institutional frameworks and incentives exist for a stable financial system.

We have the infrastructure but the effectiveness of the interaction between macro and micro needs to be continually worked on, reinforced and improved. Without effectiveness of both, the financial system is prone to excessive risk taking, short-termism, and failure. This does not serve the longer term needs of the European economy nor its citizens.

Thank you, I look forward to the discussion.

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1 See David Aikman, Jonathan Bridges, Anil Kashyap and Caspar Siegert, 'Would macroprudential regulation have prevented the last crisis?' Bank of England Staff Working Paper No. 747.

2 See Dagher, Jihad, 'Regulatory cycles: Revisiting the Political Economy of Financial Crises.' IMF working Paper (18/8).

3 See details on macroprudential policy here.

4 See List of national macroprudential authorities and national designated authorities in EU Member States and List of National Supervisors.

5 See Adverse scenario for the EBA 2018 EU-wide banking sector stress test.

6 See SSM thematic review on profitability and business models.

7 See EBA Risk Dashboard Q3 2013 and EBA Risk Dashboard Q4 2018.

8 See List of national macroprudential authorities and national designated authorities in EU Member States and List of National Supervisors.

9 See List of national macroprudential authorities and national designated authorities in EU Member States and List of National Supervisors.

10 See details of ESRB governance here.

11 See details of Macroprudential Forum here.

12 See ECB Banking Supervision Report on Recovery Plans, July 2018.

13 See FSB Global Monitoring Report on Non-Bank Financial Intermediation 2018.

14 See ESRB Report on vulnerabilities in the EU commercial real estate sector, November 2018.

15 See 'Non-bank involvement in the Irish commercial property market,' Central Bank of Ireland Financial Stability Note (forthcoming).

16 Ibid.

17 See 'Europe and the euro 20 years on,' address by Mario Draghi, at Laurea Honoris Causa in Economics by University of Sant'Anna, Pisa, 15 December 2018.