Luis de Guindos: Global financial regulation - where next? Pending tasks for regulators and macroprudential policy makers

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at the London City Week, London, 21 May 2019.

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Introduction

More than ten years have passed since the global financial crisis triggered a comprehensive regulatory reform process. Many important measures have been put in place since then. The title of the next panel discussion therefore raises a very pertinent question for global regulators: where next?

Should regulators take a long break, as some stakeholders might quietly hope? Or is there still work to be done? As you might imagine, I tend towards the view that it is not the time for regulators to rest.

In my remarks today, I will touch upon three areas that require further efforts. First, for the banking sector, we need to ensure the full and timely implementation of Basel III standards and a proper evaluation of the effects of the reforms. Second, macroprudential policy based on robust quantitative assessments should play a crucial role in sustaining the resilience of the financial sector over the financial cycle. Third, we need to see active monitoring of the non-bank financial sector, including from a system-wide perspective. This is because of the growing size and risk-taking activity of non-banks which may call for macroprudential powers and tools in this area.

Evaluating the effects of reform and implementing the Basel III package

Let me start with reform implementation and assessment. As the post-crisis reform agenda for the banking sector is now coming to an end, focus is gradually shifting towards evaluating the effects of the reforms. Such evaluation work is an essential part of the policy process. It helps us to understand whether the reforms are having the desired effect, and to identify potential unintended consequences that may have to be addressed. For these reasons, we fully support the evaluation work being carried out under the aegis of the Financial Stability Board. We are also conducting a number of evaluation projects of our own.[1]

One recent study by ECB staff, for example, finds that the reforms that are already in place have helped to make the euro area banking system safer. In particular, risks have been considerably reduced, and euro area banks are now better able to withstand shocks of the kind we have experienced in the past.[2]

On the one hand, this is a reassuring result, illustrating the progress we have made over the last few years. On the other hand, these results should not make us complacent. We need to keep up our efforts and strive for the full, timely and consistent implementation of those elements of the reforms that are still missing. For the EU, these include, in particular, the Fundamental Review of the Trading Book and the Basel III finalisation package of December 2017. The latter includes the so-called output floor, which limits the capital benefit a bank can gain from relying on internal models rather than on the standardised approach.

Some argue that these and other reform elements are not well-suited to the European market, and that they would have a disproportionate impact on EU banks. Nevertheless, while the reforms will require adjustment by some firms, the transition period – in particular for the output floor – will help to smooth the transition and make the impact manageable for banks.

Overall, I am deeply convinced that the reforms are necessary to restore confidence in the banking sector and will lead to a better prudential framework. It is thus essential that the entire Basel III package is implemented faithfully and consistently so that we can maintain a level-playing field at global level and ensure that the G20 framework delivers on its objectives.

Macroprudential policy and a macroprudential dimension to stress tests of the banking sector

The implementation of these reforms will mark the end of a long journey since the global financial crisis. Attention will shift towards ensuring the resilience of the banking sector over the financial cycle. Our macroprudential policy framework and related quantitative assessments, providing a macroprudential dimension to stress tests of the banking sector, will be cornerstones of this process.

Let me say a few words about our policy framework. Macroprudential powers were conferred on the ECB in 2014. The ECB shares responsibility for macroprudential policy in the euro area with the national authorities who actually implement macroprudential measures. The ECB is notified of hundreds of national measures each year and the ECB's Governing Council may then raise objections. The ECB can also tighten, or "top up", should measures be deemed insufficient, provided that these refer to instruments covered in European legislation – the Capital Requirements Directive and the Capital Requirements Regulation.

The combined macroprudential buffer requirements in the euro area currently range between 2.5%- to 5.75% depending on the country. Banks directly supervised by the ECB fall in the categories of globally systemically important institutions (G-SIIs) or other systemically important institutions (O-SIIs) and are thereby subject to the respective capital buffers. Four countries (soon to be five) have activated the systemic risk buffer, while two have activated the countercyclical capital buffer with a further three announcing positive countercyclical capital buffer rates for the near future.[3]

Looking ahead, macroprudential policy should play an important role in ensuring the resilience of the banking sector to adverse shocks. At this stage of the financial cycle, is would still be desirable for a number of euro area countries to build-up macroprudential buffers, in my view. The crisis taught us that we must be vigilant in safeguarding the resilience of our financial system at times when vulnerabilities are building up.

The slower growth momentum we are seeing increases the risk of tail events, in other words, shocks that are unlikely to occur, but would have a significant impact on the financial system and the economy if they did. Bank capital plays a crucial role in absorbing these tail risks: it provides solvency insurance and makes it more likely that banks will be able to continue to provide credit during a downturn.

From a macroprudential perspective, then, the continued build-up of buffers could therefore be justified, especially in those countries where the long upturn may have led to an underestimation of credit risk or where private indebtedness is particularly high or rising.

Ensuring that buffers are adequate is not just a task for regulators. It is in the interest of banks too. It contributes to restore confidence in the sector. Improving bank profitability in a sustainable way, for example by adjusting business models, would help banks improve their capital generation capacity while also making it easier for them to raise capital externally when needed.

This brings me to the concept of macroprudential stress testing, a key analytical tool that helps us assess the resilience of the financial system over the cycle. Unlike regular supervisory stress testing, it accounts for banks' reaction to adverse circumstances and its impact on the real economy that may further stress banks' operating environment. As such, it can provide a more complete picture of banks' performance and capital needs. It can therefore lead to more realistic

results for policy use.

The ECB's macroprudential stress test framework not only tracks the resilience of individual banking institutions but also accounts for how banks interact with each other and how their actions feed back to the economy. It internalises the fact that banks may deleverage in response to negative developments. It subsequently, takes into account the extent to which this adverse credit supply shock may aggravate the downturn leading to a further deterioration in banks' balance sheets.

This framework complements the EU-wide stress testing exercises conducted under the aegis of the European Banking Authority (EBA), which are mainly of a micro-prudential nature. A macroprudential exercise conducted in 2018 for banks directly supervised by the ECB[4] using the baseline and adverse scenarios of the recent EBA stress test, confirmed the general resilience of the euro area banking system. Bank deleveraging and feedback to the real economy would however lead to a substantial drop in lending to the non-financial private sector. This would lead to an additional fall in GDP of 1.6% across the euro area, on top of the original GDP shocks in the adverse scenario over the three-year horizon.

This analytical framework can also help us to calibrate macroprudential policies. The framework shows, for instance, that the timing of the activation of capital-based measures matters for their effectiveness. If a new policy tool is introduced in good times, banks are able to build up additional capital by retaining their profits, and they do not need to shrink their loan books to improve their capital ratios. A new capital policy tool that is introduced in bad times however is likely to trigger a reduction in credit and place an additional drag on the economy. Bad timing increases the cost of macroprudential and regulatory interventions, potentially rendering such measures counter-productive.

Risks and macroprudential policy for the non-bank financial sector

Let me now turn to the non-bank financial sector which is becoming ever more important for our financial system. In my view, work on the regulatory and, in particular, the macroprudential framework for this sector is still in its early stages.

The share of market-based financing is likely to continue growing, not least in view of the efforts made in the context of the capital markets union, which will have tangible benefits for the euro area economy as a whole. More integrated and deeper European capital markets will promote a more diversified funding base for the European corporate sector. This, in turn, will help firms weather a possible shock to the banking sector and a resulting decline in the supply of bank credit, as they would be able to draw on other – market-based – funding sources. But this can only happen if market-based finance remains resilient in the face of such a shock.

The benefits of a growing non-bank financial sector are currently accompanied by potential vulnerabilities. In search of higher yields, non-banks have accumulated more credit and liquidity risks on their balance sheets. This renders them more vulnerable to the low credit quality and high indebtedness in some segments of the corporate and government sector. Moreover, non-banks may be contributing to the current cyclical underpricing of risk and helping to amplify the upswing in the wider financial cycle. This is partly because non-banks are subject to lighter regulatory constraints which in some cases allow them to take on more risks. If risks were to unwind in a disorderly manner we could see funding flows dry-up and funding conditions in the real economy affected more broadly.

If we were to reap the benefits of a deep and integrated European capital market, then, non-bank financing needs to develop in a sustainable manner. In this changing environment, it is important to strengthen our risk identification and monitoring framework. International cooperation is needed to develop tools for stress testing but now at system-wide level, in the form of models that incorporate both banks and non-banks, consider feedback and amplification from the

interaction between sectors and look for tipping points and non-linear responses.

From a regulatory perspective, at least two lines of defence are needed to counter evolving risks. First and foremost, prudential standards must remain solid in the non-bank financial sector. But this alone will not be sufficient if risks evolve more broadly and across institutions. An extension of the macroprudential toolkit to the non-bank financial sector is needed, thereby providing the authorities with the means to address risks at the system level. While the macroprudential framework for banks is relatively well developed and gives authorities tools with which to address cyclical and structural systemic risks, the framework for non-banks is still in its infancy and needs further development. Such a framework would need to be capable of identifying and addressing the key fragilities and externalities stemming from the non-bank sector, and provide authorities with the tools that would allow them to achieve this in an efficient and effective manner.

Concluding remarks

Let me conclude. The regulatory community has been striving to establish a framework that makes our financial system more resilient. While much has been achieved, I do not believe that we can now rest on our laurels.

On the contrary, in particular the three remaining tasks outlined today require our continued effort. The Basel III package for the banking sector should be implemented in a timely and consistently manner across jurisdictions thereby ensuring that a level-playing field is preserved. As attention shifts towards maintaining the resilience of the banking system over the financial cycle, macroprudential policy and related quantitative assessments become prominent. Adding a macroprudential dimension to stress tests of the banking sector is essential. Finally, developments in the non-bank financial sector call for an active monitoring and the extension of the macroprudential policy toolkit to this sector.

Thank you for your attention.

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1 See the FSB framework for evaluating the effects of the G20 financial regulatory reforms.

2 See, for example, Carmassi, J., Corrias, R. and Parisi, L. (2019), "Is taxpayers' money better protected now? An assessment of banking regulatory reforms ten years after the global financial crisis", *Macroprudential Bulletin*, Issue 7, ECB, March. The results of this analytical work show that, on the one hand, the average probability of default (PD) of euro area banks decreased from 3.5% in 2007 to 1.1% in 2017, less than a third of its pre-crisis value. On the other hand, banks' loss-absorbing capacity increased from 7.2% of total assets in 2007 to 16.9% or 55.5% of total assets in 2017, depending on the assumptions on the scope of the bail-in. This increase in loss-absorbing capacity was due to the introduction of larger capital buffers and the new resolution framework, notably the bail-in tool and the potential intervention of the Single Resolution Fund. Considering the combination of decreased PDs and enhanced loss-absorbing capacity, the ability of the banking system to absorb losses while minimising the cost to taxpayers has increased more than three-fold over the last ten years under the scenario of a narrower scope for the bail-in tool, and twelve-fold under the scenario of a broader scope for the bail-in tool.

3 More details are available on the ECB website.

4 See Budnik K. (2019), "Abird's-eye view of the resilience of the European banking system: results from the new macroprudential stress test framework", *Macroprudential Bulletin*, Issue 7, ECB, March.