cutting through complexity

Financial stability: how to lean against the wind?

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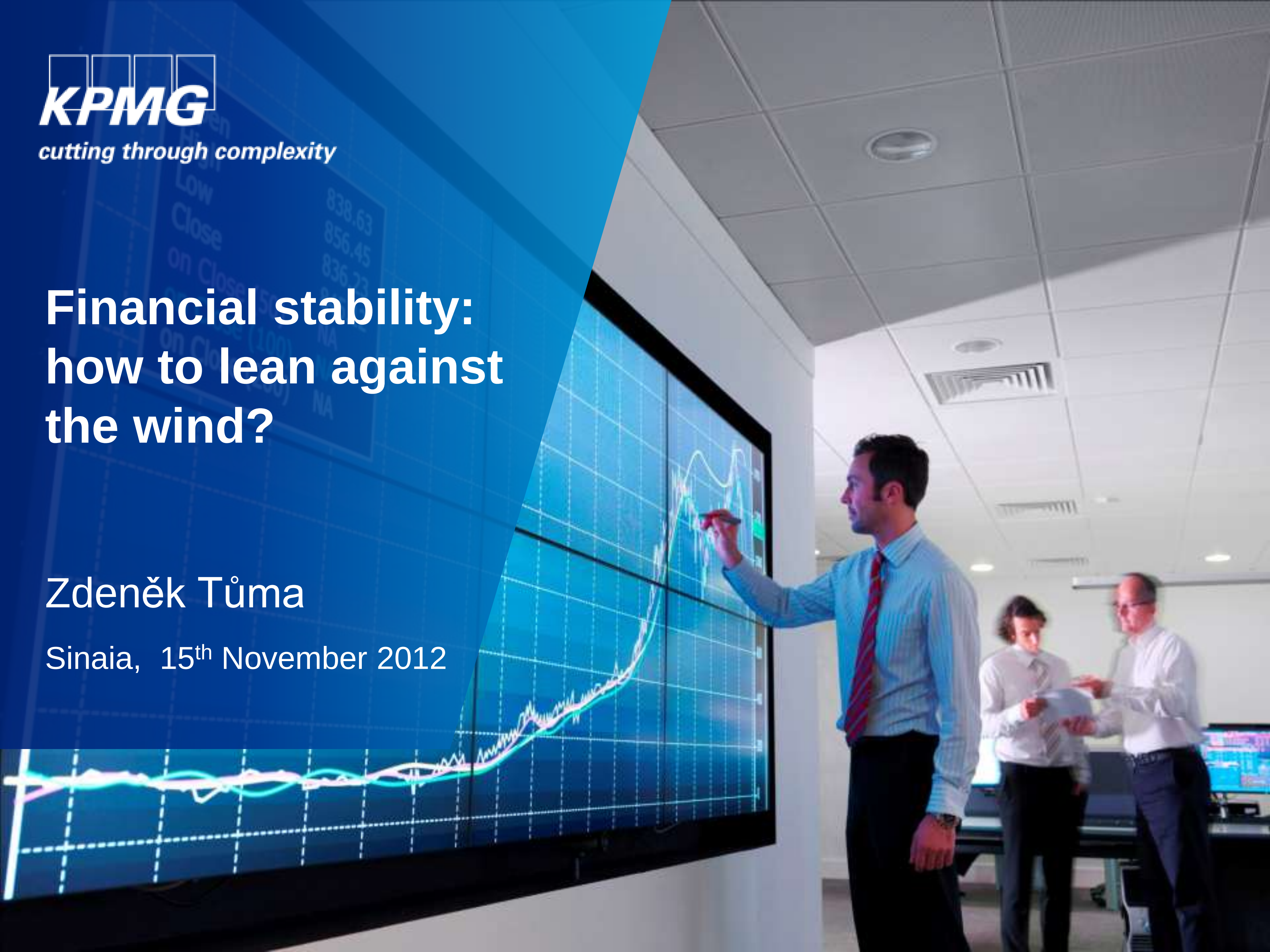
Sinaia, 15th November 2012



Main points

- **Institutional framework**
  - Central bank as natural harbour
  - Way of thinking
  - Processes and decision making within the bank
- **Tools**
  - Monetary policy
  - Supervisory toolkit
  - Others?
- **Complexity and structure of financial sector**
  - Can we recognize, manage and supervize the risk in today´s financial sectors?

Institutional framework

- **Financial stability has not been a new issue but there was certainly more emphasis in the previous decade**
  - While the price stability was preserved, there was (obvious) overheating in other markets (real estate, equities, …)
  - Many discussions about „leaning against the wind“ but less clear how
  - Central banks (BIS) were source of the analysis and discussion
  - CBs started to prepare Reports on financial stability
  - Financial stability more dificult to define in terms of objectives, framework, tools …
  - How does the transmission mechanism look like?
  - Mentality/way of thinking is different – implications for the organisation

Institutional framework: „definition“ – compare with the price stability

- **Under financial stability we typically understand a situation in which**
  - financial system fulfils its functions without disturbances and negative effects on current and future development of the economy
  - and at the same time shows a high degree of resilience towards adverse shocks

- **Financial stability analysis is then defined**
  - as a study of circumstances under which the interaction of financial markets volatility, excessively leveraged households‘,firms‘ and government‘s balances and macroeconomic factors and policies can invoke a crisis

Institutional framework: the Czech case

- The Czech Republic came through a period of major financial instability during 2nd half of 1990s
- The natural response was to set financial stability as important goal of CNB‘s policies
- Up to 2004, the goal was pursued as rather informal one in a historical memory-based manner
- In early 2004, a project team established to recommend the Bank Board how to
  - define financial stability goal
  - express it in the legislation
  - organize financial stability analyses within the CNB
- The findings of the team lead to legislative and organizational changes

Institutional framework: the Czech case

- Till March 2006 no explicit financial stability task in the Act on the CNB
- We derived the mandate to perform financial stability analyses indirectly, namely from
  - Article 2 (2c): CNB shall contribute to the safety, soundness and efficiency of payment systems
  - Article 2 (1): CNB shall support the general economic policies of the Government leading to sustainable economic growth
  - Article 2 (2d): CNB shall see to the sound operation and purposeful development of the banking system in the Czech Republic

- However, with the amendment of the Act as of April 2006 (integration of financial supervisors into the CNB), the financial stability task of the CNB became more explicit
  - Article 2 (2d): CNB shall… contribute to stability of the (Czech Republic's) financial system as a whole.

Institutional framework: the Czech case

- 2011 – changes to the CNB act prepared (expected to be effective from 2013): enhancement of the mandate of the Czech National Bank (hereinafter "CNB") as an institution responsible for financial stability,
  - Article 2, (1) The primary objective of the CNB shall be to maintain price stability. **In addition, the Czech National Bank shall work to ensure financial stability and the safe and sound operation of the financial system in the Czech Republic.**
  - Article 2, (2) The CNB shall perform the following tasks:
    - a) set monetary policy …
    - e) **set macroprudential policy** by identifying, monitoring and assessing risks jeopardising the stability of the financial system and, in order to prevent or mitigate these risks, contribute by means of its powers to the resilience of the financial system and the maintenance of financial stability; where necessary, it shall cooperate with the relevant state authorities in setting macroprudential policy.

Institutional framework: the Czech case

- Several options considered in 2004: independent division, part of existing department (banking supervision, economic research, monetary)
- Financial Stability Unit (FSU) established in July 2004 as a new „independent“ financial stability unit of the Economic Research Department
  - small - 6 economists (but also occasionally people from other parts of CNB participate in financial stability analyses and writing the Report),
  - financial stability analyses at the cross-section of macro, real economy and financial sector analyses, but slightly different focus: thus FSU independent of both monetary and financial supervision department(s)
  - relative independence: strategic, legal and communication reasons
- 2007 – Economic Research and Financial Stability Department
  - individual management of both activities that share joint administrative infrastructure
- 2010 – Financial Stability Department
  - 2011 – responsible for the ESRB agenda

Institutional framework: the Czech case

➢Financial Stability Department structure:

- **Macroprudential Policy Unit**
  - analyses of vulnerability of core institutions
  - stress testing
  - FS indicators and early warning systems ..
- **Systemic Risk Unit**
  - market and funding liquidity
  - financial markets, nonbanks
  - network risks, common exposures, contagion …
- **Macroprudential Analyses Unit**
  - analyses of real economy (households and firms)
  - macroeconomic development and external economy
  - real estate market …

Institutional framework: the Czech case

- Crisis team 2008-2009
  - after the outset of crisis a multi-department monitoring team establised
  - originally meeting frequently, later monthly and now quarterly

- Macrofinancial Panel (from May 2009 till February 2012)
  - one day before quarterly monetary meeting with new forecast presentations and discussions with the Board
  - simulations of various crisis scenarios run in the panel structure
  - departments: financial stability, research, monetary policy department, supervision, regulation, financial market operations, risk management

- Regular board meetings on financial stability issues (from May 2012)

Financial stability toolkit

- True (genuine) macroprudential tools are those which can be applied in the form of rules and can therefore take the form of built-in stabilisers.
  - They should automatically limit the procyclicality of the financial system or the risky behaviour of individual institutions.
  - They should be explicitly focusing on the financial system as a whole and endogenous processes within it.
- In addition to true macroprudential tools, various microprudential regulatory and supervisory tools can be used for macroprudential purposes.
  - If these tools are applied not to individual institutions, but across the board to all institutions in the system, they can be regarded as macroprudential instruments.
  - Measures of this type, along with monetary policy tools, fiscal policy tools and tax measures, have been applied in many countries in the past in an effort to slow excess credit growth.

Financial stability toolkit

- Microprudential approach (for example banking supervision):
  - Prevention through enforcement of compliance rules and regulations of prudential behaviour.
  - Reation when breaching of the rules/regulations is identified and when prudential indicators got worse.
- Microprudential approach:
  - Prevention not based on rules and regulations, but on analyses and indicators of systemic risk (as with monetary policy).
  - Prevention can work only through timely and forward-looking action.
  - Paradox of financial (in)stability – most serious risk emerge in good times when prudential indicators look well (they are getting better).
  - Correction action must therefore occur in good times (as with monetary policy).

Financial stability toolkit: examples

- Countercyclical capital buffers
- Ceiling on leverage ratio
- Provisioning through the financial cycle
- Increased risk weights for certain type of loans
- Ceilings on LTV ratios for residential real estate
- Maturity transformation limits (liquidity coverage ratio)
- Capital and/or liquidity surcharges for size/complexity….

- Monetary policy?
- Fiscal policy?

Complexity and structure of financial sector

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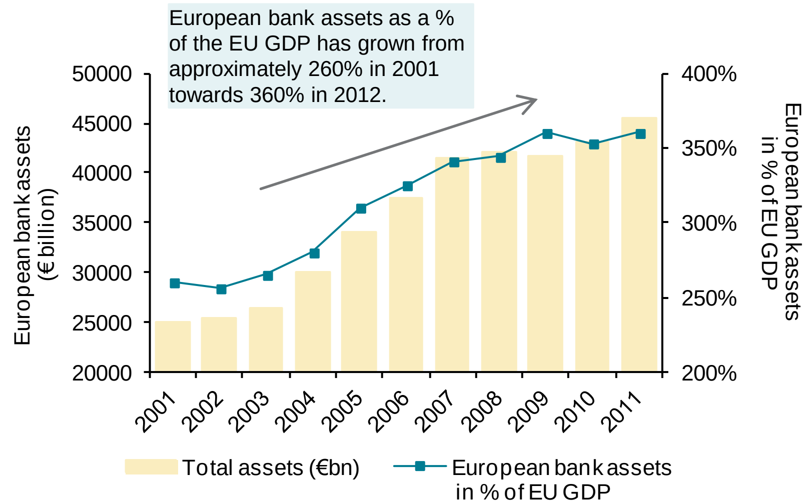
Background and mandate to the Liikanen Group

Background of the Liikanen group:

- Commissioner Barnier announced in November 2011 his intention to set up a High-level Expert Group to examine possible reforms to the structure of the EU's banking sector.
- Chairman was Erkki Liikanen, Governor of the Bank of Finland and a former member of the European Commission. The Group's members were announced on 22 February. The Group presented its final report to the Commission on 2 October 2012 and published proposals on 2 October.
- Its mandate was to determine whether, in addition to ongoing regulatory reforms, structural reforms of EU banks would strengthen financial stability and improve efficiency and consumer protection, and if that is the case to make proposals as appropriate.
- The Group was told to have regard to existing regulatory proposals in the EU and globally and assess added value of structural reform.
- Group was to in particular pay attention to existing structural reforms including the US Volcker rule and UK ICB / Vickers proposals.

European bank asset development



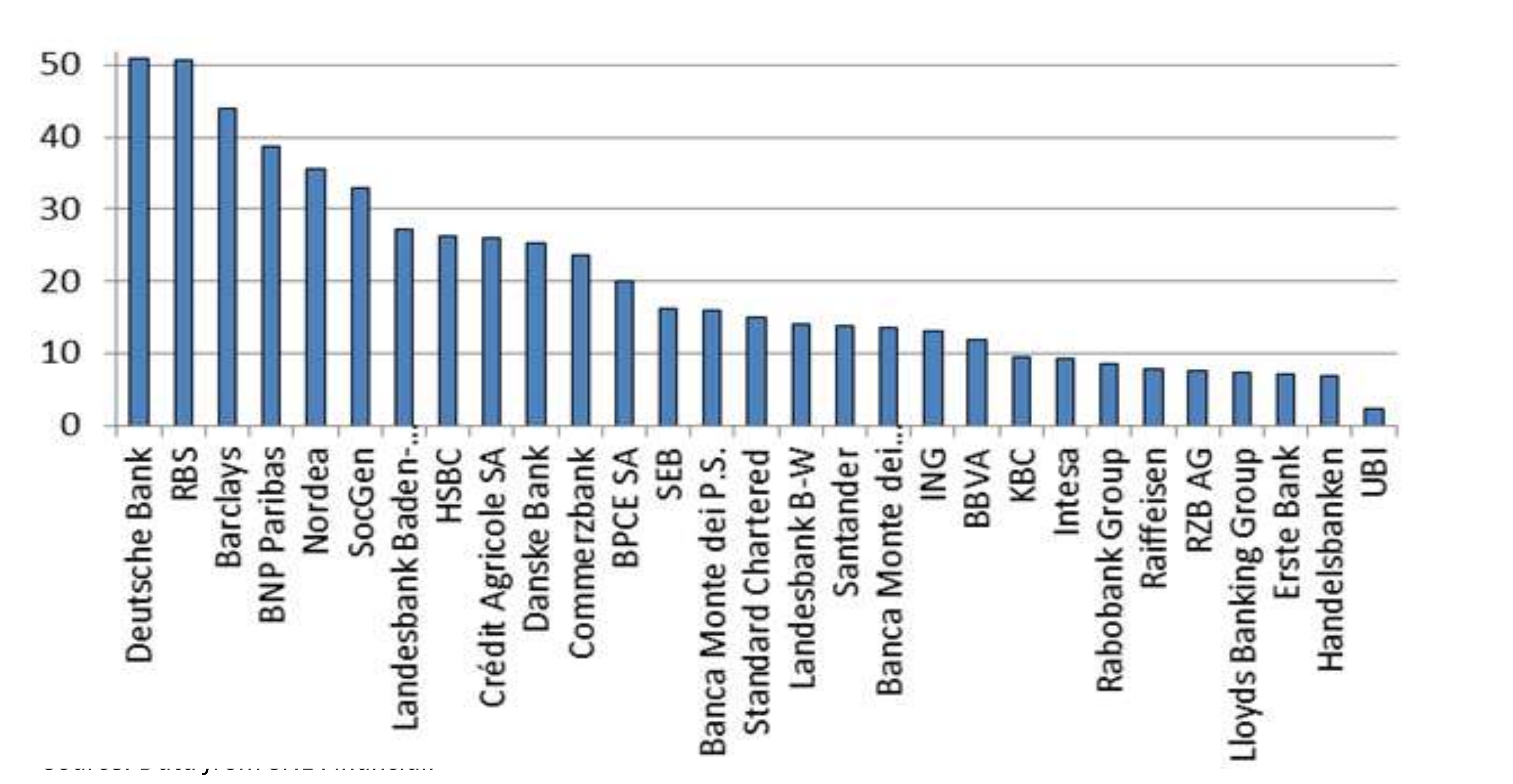
Source: ECB data

In making recommendations The Liikanen Group were to:

- Reduce risks in banking system as a whole
- Reduce the risks that individual firms pose to financial system
- Reduce moral hazard by making market exit a viable option
- Promote competition
- Maintain integrity of the internal market

Some banks focus more on trading activities

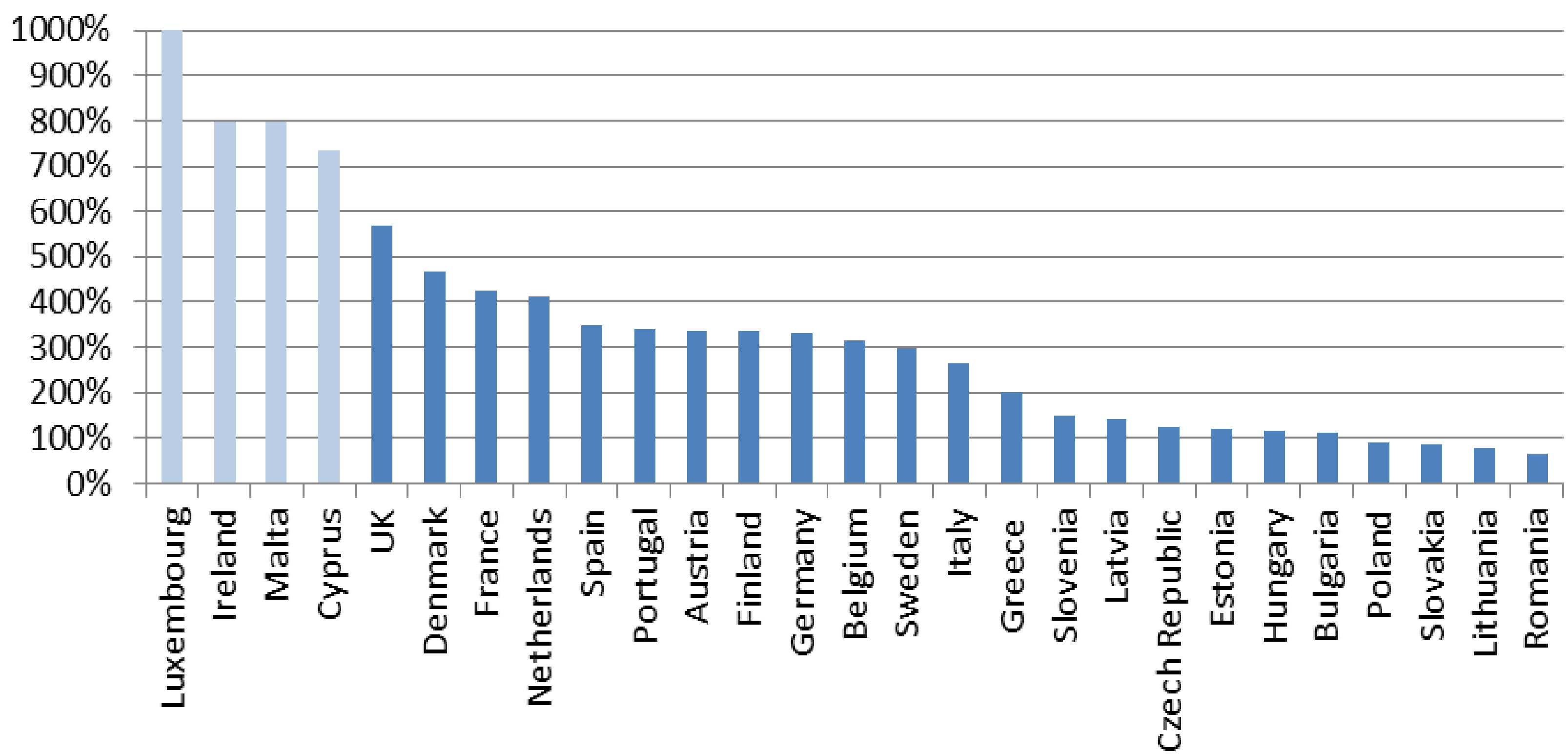
Total assets held for trading (as % of total assets), 2011



Size of banking sector in EU27

Total assets of MFIs in the EU, by country (in % of national GDP)

Notes: Assets as of March 2012, GDP data for end 2011. Based on aggregate balance sheet of monetary financial institutions (MFIs). Vertical axis cut at 1000% (ratio for Luxembourg is 2400%). Data on MFI includes money market funds. Source: ECB data. Eurostat for GDP data.



Problem

- Complexity (inadequate bank management, monitoring, supervision and resolution)
- Excessive risk-taking (trading, lending, funding)
- Limited loss absorbency
- Intra-group subsidies

- Interconnectedness
- Limited resolvability
- Bank-sovereign feedback loop

- Inadequate EU institutional framework
- Excessive focus on intra-financial business
- Competitive distortions and implicit subsidies

Result

Increased probability of failure

Increased impact of failure

Reduced internal market efficiency and level-playing field

Current regulatory reforms

Capital, leverage	CRD IV / CRR G-SIB requirements
Liquidity	CRD IV / CRR
Reducing contagion, complexity	EMIR, MiFID II, proposals on CSDs and securities law, shadow banking
Corporate governance	CRD III, CRD IV
Transparency, data quality	Review of IFRS standards, audit proposals, rating agency regulation
Supervision	SSM proposals, towards Banking Union
„Recovery and resolution“	Resolution and crisis management proposal
Depositor protection	DGS proposal

Summary of recommendations

1. Mandatory separation of proprietary and significant other trading activities
2. Additional separation of other activities conditional on the recovery and resolution plan
3. Possible amendments to the use of bail-in instruments as a resolution tool
4. A review of capital requirements on trading assets and real estate related loans
5. Strengthening the governance and control of banks

1. Mandatory separation

- Mandatory separation to a “deposit bank" and "trading entity„
- Activities separated to the trading entity:
  - At least proprietary trading, market-making, and loans/loan commitments/ unsecured credit exposure to hedge funds, SIVs, and private equity investments
- Activities that are permitted to deposit banks:
  - Client-driven transactions that fall within narrow risk position limits;
  - Securities underwriting.
- Activities only permitted to deposit banks:
  - Funding with insured deposits.
  - Supply payment services

1. Mandatory separation

- Separation would only be mandatory if the activities to be separated amount to a significant share of a bank's business.

- The decision to require mandatory separation is done in two stages:
  - A bank advances to the second stage examination if a bank's assets held for trading and available for sale exceed (1) a relative examination threshold of 15-25% of the bank's total assets or (2) an absolute examination threshold of EUR100bn.
  - Supervisors would determine the need for separation based on the share of assets to which the separation requirement would apply. This threshold, as share of a bank's total assets, is to be calibrated by the Commission.

A comparison of structure reforms

Not in scope	Retail only	Retail allowed	Trading only

US Volcker – 'prop trading' ban by 2014

Retail deposits	SME deposits	Payment services	Retail lending	SME lending	Trade finance	Corporate lending	Investment advice	Broking	Derivatives	Capital markets	Prop trading

Legal uncertainty on 'permitted' and 'prohibited' – distinction from market making, hedging and underwriting unclear…

EU Liikanen – trading ring-fence by TBC

Retail deposits	SME deposits	Payment services	Retail lending	SME lending	Trade finance	Corporate lending	Investment advice	Broking	Derivatives	Capital markets	Prop trading
Wealth mgt, UCITS				Loan syndication, interbank lending, securitisation, non-bank hedging*,				Loans / unsecured credit exposures to hedge funds, SIVs, PE			

Still only recommendations but European Commission launched immediate consultation and has previously indicated legislation in 2012

UK Vickers – retail ring-fence by 2019

Retail deposits	SME deposits	Payment services	Retail lending	SME lending	Trade finance	Corporate lending	Investment advice	Broking	Derivatives	Capital markets	Prop trading

Definition of 'principal trading' leaves uncertainty over which activities may be banned from the ring fence…

2. Additional separation

- Producing an effective and credible resolution plan may require the scope of separated activities to be wider.

- Operational continuity is key objective

- Supervisory discretion, but EBA is invited to play an important role in harmonising RRPs and their assessment.

- EBA to develop standards for triggering additional separation based on:
  - Complexity of trading instrument;
  - Complexity of organisation (governance, legal structure); and
  - Absolute and relative size of risk positions.

3. Strengthening bail-in

- Support of bail-in as a resolution tool:
  - Improves loss absorbency;
  - Improves market discipline; and
  - Reduces implicit subsidy.

- Need to increase predictability of the use of the bail-in instrument:
  - Scope of bail-in: bail-in requirement to be used explicitly only to a certain category of clearly defined debt instruments;
  - Phased-in over an extended period of time;
  - Requirement could be satisfied by common equity as well; and
  - Bail-in instruments should not be held within the banking sector.

4. Capital requirements review

- General:
  - Strong and coordinated actions to improve the consistency of internal models across banks.
- Trading entity:
  - Commission to assess whether future result of Basel Committee trading book review sufficient to cover risks of every type of EU bank.
- Deposit bank:
  - Supervisors to make sure that capital requirements include sufficient safeguards against substantial property market stress;
  - Strict LTV and/or LTI caps should be part of macro-prudential toolbox in all Member States.

5. Governance and control

- Governance and control:
  - Fit and proper tests to ensure management ability run large and complex banks

- Risk management:
  - Risk and control management to report to Chairman in parallel to CEO

- Incentive schemes
  - Share of variable remuneration should be in bail-in bonds;
  - Assess further restrictions on level variable income to fixed income;
  - Regulatory approach (i) stipulating more absolute levels to overall compensation and (ii) framing board and shareholder approval.

Thank you

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