The Joint NBR and IMF Financial Stability Seminar (11th edition)

The day after tomorrow: the future of financial intermediation

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***Keynote speech by Carlos Costa, Governor of Banco de Portugal*[1]**

High Level Roundtable on Resolution & Financial Stability

Ladies and Gentlemen,

It is a great pleasure to be part of such a distinguished roundtable on resolution and financial stability.

I am grateful for the National Bank of Romania's invitation to address you today on such timely and relevant topics.

The need to move from 'bailout' to 'bail-in' led to the widespread adoption of resolution regimes in the aftermath of the recent global financial crisis.

[1] As prepared for delivery.

However, in Europe, the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) have entered into force without the full recovery of the European Union's economies and without banks having significantly strengthened their ability to absorb losses.

Risks are augmented by the fact that we are running an incomplete Banking Union where a backstop to the Single Resolution Fund (SRF) and a European Deposit Insurance Scheme (EDIS) are still missing.

Consequently, the regulatory requirements underlying the BRRD and the Banking Union's current set-up may themselves contribute perversely, weakening banks and undermining financial stability.

Indeed, while supervisory and resolution decisions are taken at European level, financial stability remains mostly a national responsibility; this is so despite national tools having a much more limited scope, in a context where there is a clear misalignment between liability and risk control.

We have recently experienced this first-hand in Portugal with the case of Banco Popular Español. As publicly recognised by Ms. Danièle Nouy, "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."

It is thus essential to complete the Banking Union while properly aligning the interests of those entrusted with decision-making powers, those bearing liability and those with accountability, so as to ensure fair and balanced decisions.

In my remarks today, I will address four of the most pressing issues that we need to tackle urgently, namely: (1) solvency definition, (2) liquidity in resolution, (3) loss absorption capacity, and (4) safety nets.

1. Solvency definition

Proper incentives should be established for all the relevant stakeholders in the run-up to and after the adoption of a resolution scheme.

This starts with the definition of banks' solvency. Recent calls to reflect on how to define solvency, in particular its forward-looking aspect, risk adding an unwarranted degree of discretion.

Such discretion, in turn, may cause an increase in the cost of debt and equity for European banks, whether large or small, since the relevant triggers for a failing or likely to fail (FOLTF) determination would be difficult to predict and make uniform.

The solvency definition should be consistent over time and within the regulatory framework. It should be objective, traceable and reliable for third parties.

Solvency should also be viewed from a ‘going concern’ perspective, which is intrinsically associated with CRD IV/CRR provisions. The first, and main, step in solvency determination should be a point-in-time assessment of compliance with minimum capital requirements (Pillar 1 requirements).

Any ‘forward-looking perspective’ should only play a role if there are relevant future events which are known and quantifiable at the time of solvency determination.

2. Liquidity in resolution

Liquidity support for banks under resolution emerged as a key topic in the aftermath of the recent events in Spain and Italy.

The Single Resolution Board (SRB) has recognised that work on identifying private and public sources of funding is a priority, including the potential role and limits of the Single Resolution Fund (SRF), the central banks and Member States.

Also, the SRB and the Single Supervisory Mechanism (SSM) have called for the adoption of adequate moratorium powers for supervisory and/or resolution authorities covering all liabilities.

However, market participants have already recognised that the moratorium approach is only superficially appealing. It can have destabilising effects by amplifying incentives for a run on banks by investors, counterparties and depositors at the earliest sign of distress.

The moratorium tool can also lead depositors to withdraw remaining amounts in their accounts after the bank re-opens, a risk that can increase if depositors absorb losses during the resolution process.

Suitable alternatives need to be developed.

In the run-up to resolution, there is a risk that the available collateral would be pledged for the most part. The provision of Emergency Liquidity Assistance (ELA) can reduce the availability of collateral during and after resolution.

In this sense, central banks and resolution authorities have a common interest in resolving banks in a timely manner, i.e. before asset encumbrance reaches uncomfortably high levels and collateral runs out.

The potential use of Government Guaranteed Bank Bonds (GGBBs) should be assessed in a timely fashion in regard to the trade-off between extended liquidity support (via ELA and/or GGBBs), the resolution objectives and the implications for solvency.

In view of the existing mismatch between European oversight and national liability, the objectives and interests of the several stakeholders involved are not aligned.

This needs to change! Courageous decisions are needed.

To begin with, the SRF needs to be strengthened. Policymakers and the SRB should reconsider the policy of excluding *a priori* the use of the SRF in resolution plans.

Additionally, the provision and risk-taking of ELA for Significant Institutions should be shared by the Eurosystem instead of remaining at national level.

Only by bringing the financial consequences up to European level where supervisory and resolution powers stand can we align the incentives of the several stakeholders.

Still, this would not be enough.

Even a well-recapitalised bank post-resolution may experience increased liquidity needs generated by market volatility or by asymmetrical information on the bank's viability.

New tools should therefore be developed. In this context, the pragmatic approach of the Bank of England to the provision of liquidity in resolution should be carefully exploited.

This approach involved putting in place a new flexible Resolution Liquidity Framework providing the tools to lend to banks which are in a resolution led by the Bank of England, as a complement to the existing liquidity arrangements.

Consistency with the Eurosystem's counterparty framework and lender of last resort should be ensured.

3. Loss absorption capacity

The entry into force of the BRRD and the SRM before banks had the possibility to significantly strengthen their ability to absorb losses implies that, as of today, many institutions cannot be deemed resolvable without extending the bail-in requirements to the level of senior debt or deposits.

Resolution authorities need to be able to rely on alternative sources of financing such as resolution funds to finance the resolution of credit institutions, especially in the transitory period in which loss-absorbing capacity is not available.

However, recourse to resolution funds is severely constrained by the current internal loss absorption requirements (8% of total liabilities and own funds) and by the actual limits on the use of the resolution funds (5% of total liabilities and own funds).

This, in turn, prevents the basic objectives of resolution – such as ensuring continuity of critical functions and avoiding significant adverse effects on financial stability – from being achieved.

Also, in the current context where MREL compliance is far from being attained, whenever an event changes risk perception, short-term investors in that institution's 'bail-inable' securities will trample over each other to reach the exit before bail-in.

As they form a disorderly queue at the exit, the price of these securities will collapse, triggering a series of contagious mechanisms including rating downgrades and ultimately bank runs, potentiated by the corporate deposit base.

Hence, the current status not only implies that resolution might be less effective than expected in safeguarding financial stability but also means that it might be creating perverse incentives and could potentiate runs.

Due attention should therefore be given when deciding on the quality and location of MREL as well as the corresponding phase-in period, bearing in mind the incentive structure of MREL investors.

Moreover we must be cognisant that it is simply unfeasible for the banking sector collectively to issue the significant amounts of loss-absorbing instruments required in the short to medium term, and that such requirements cannot be met without the risk of aggravating banks' funding costs and profitability.

In this context, due care should be given to public announcements about MREL shortages and timings.

4. Safety nets

In the aftermath of the crisis, 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.

While this should be the norm, flexibility should be preserved.

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.

Such misjudgement has not gone unnoticed and does not come without consequences.

In the aftermath of the events in Italy over the last few months, a growing view emerged that the credibility of the Banking Union was under threat.

Some noted that in the future, investors, when faced with similar situations, will find it hard to believe in the envisaged single rulebook and in the consistency of the resolution framework as they perceive bank resolutions will always wipe out subordinated creditors in full, and will stop short of bailing in senior creditors.

On the other hand, others have highlighted that the Italian cases showed the system could bend rather than break when challenged. It was a demonstration that (i) banking crises require solutions and tools that create confidence and allow for time to gradually recover value, and that (ii) public intervention must not be demonised.

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

Let me conclude.

One should not underestimate how much has been achieved since the 2007 crisis. Nevertheless, the foundations of the European architecture are still not sufficiently robust to withstand the impact of a future crisis and this should be the focus of policymakers and relevant institutions.

Decisive political will to move forward with the completion of the Banking Union is required. Otherwise, we risk fragmenting the single market and only realising we missed this opportunity when the next crisis hits.

Thank you for your attention.